# Report of the Joint Treasury–SEC–Federal Reserve Board Study of the Government-Related Securities Markets

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December 1980

# PREFACE

The following study of the government-related securities markets was prepared by the Department of the Treasury, the Federal Reserve System and the Securities and Exchange Commission (SEC) pursuant to a request by Senator Harrison A. Williams, Jr., Chairman of the Subcommittee on Housing and Urban Affairs, for information and advice on problems arising in these markets, particularly in the forward market for mortgage-backed securities guaranteed by the Government National Mortgage Association.

The study deals only with the cash and forward markets for certain government-related securities and does not attempt an evaluation of either the futures market for these securities or the proposed options market in the same securities.

It should be noted that, although the Treasury staff has fully participated in this study, the Administration has not taken a position on the study's recommendations. The SEC and the Board of Governors of the Federal Reserve System have endorsed the recommendations.

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# CHAPTER I

## INTRODUCTION AND SUMMARY OF STUDY'S CONCLUSIONS AND RECOMMENDATIONS

This report presents the results of a study of markets for government guaranteed securities and other related securities that has been conducted jointly by the U.S. Treasury, the Federal Reserve and the Securities and Exchange Commission (SEC). The study was prompted by the widespread problems--attributable in great part to abusive trading practices--recorded in government guaranteed securities markets in recent years, particularly the market for mortgage-backed securities guaranteed by the Government National Mortgage Association (GNMA). Trading activities in these markets are currently exempt from federal regulation--except for the SEC's antifraud authority. The purpose of the study was thus to consider whether federal regulation should be extended to these markets, and, if so, to develop proposals for how this might best be accomplished.

In the course of the study, interviews were conducted with federal agencies that either guarantee or issue securities currently exempted from SEC regulations or are responsible for regulating financial institutions that invest in such securities. Interviews were also held with various entities in the private sector including interested trade associations, issuers, dealers and investors in government guaranteed securities. 1/ The cases in which the SEC has instituted actions in response to complaints about abusive practices in government related securities have also been reviewed. Other background information was obtained from within the agencies conducting the study.

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1/ See list of those interviewed at the end of this chapter.

The following chapters present the results of these efforts. Chapter II provides a broad overview of federal and federally assisted borrowing and reviews the history of legislation that has exempted such debt securities from SEC regulation. Chapter III presents a summary review of the major characteristics of securities, the market participants, and the trading practices in the government related securities markets. The discussion is supplemented by five appendices that provide more detail on the market sectors described. Chapter IV provides a review of problems and abuses that have developed in various sectors of the government related securities market and an analysis of regulatory measures that, if imposed, would reduce such abusive practices. An appendix providing a detailed review of cases in which the SEC has instituted legal actions accompanies this chapter. Chapter V reviews the various actions taken by federal agencies charged with regulating issuers of and investors in government guaranteed mortgage-backed securities and other government related securities, and also discusses the efforts made by the securities industry to establish a self-regulatory framework.

Finally, Chapter VI examines the question whether regulation should be extended to brokers and dealers in government related securities and sets forth conclusions and recommendations. These conclusions and recommendations are summarized in the following sections of this chapter. They are also embodied in a legislative proposal that is being submitted by the three agencies in connection with this study. That legislative proposal is presented as Appendix B to Chapter VI.

## Conclusions

After carefully reviewing and evaluating problems which have arisen in the trading of government related securities and taking into account the opinions of other interested federal agencies and market participants, it is the joint view of the Treasury, Federal Reserve and SEC that there is need to extend government regulation to forward trading in GNMA guaranteed mortgage-backed scurities. Losses suffered by market participants trading in these securities have been substantial. It is recognized that the potential for problems to develop in the future has been reduced as a result of the rules and guidelines imposed by GNMA on issuers and by federal regulatory authorities on financial institutions that invest in these securities. Prospects for serious abuse, however, appear to remain unacceptably great. In particular, it is still possible to assume large positions in GNMA securities for long delayed delivery without being required to provide an initial or maintenance margin--the practice that has contributed to a high degree of speculative activity and, thus, to losses incurred by dealers and investors in these securities.

To date, there have been only a few instances in which investors have incurred losses in forward transactions in mortgage-backed securities guaranteed by the Federal Home Loan Mortgage Corporation (FHLMC) because of abusive trading practices. Nevertheless, these securities are also traded on a forward delivery basis without margin, and thus the potential exists for serious problems to develop in this market sector similar to those recorded in GNMA forward trading. Accordingly, it has been concluded that forward

trading in FHLMC guaranteed mortgage-backed securities should come under the same mantle of regulation as that imposed on GNMA forwards.

As for the other sectors of the government and government related securities markets, it appears that the small number of problems in these sectors does not presently warrant elimination of the exemption of these securities from formal federal regulation (except for the SEC's antifraud statutes). There have been only a few cases of abusive practices that have involved these other sectors, and losses have been relatively small compared with those recorded in mortgage-backed securities as well as with the total volume of transactions in these markets. Moreover, a major portion of these markets is subject to the informal oversight of the Federal Reserve System and the Department of the Treasury.

## Recommendations

The regulatory system that appears best suited to extend regulation over forward trading in GNMA and FHLMC guaranteed mortgage-backed securities is one based on self regulation with governmental oversight, a system that has worked well in other sectors of the financial markets. Accordingly, it is proposed that a new self-regulatory organization, which would be named the Federal Mortgage-Backed Securities Rulemaking Board (Board), be established to promulgate rules to be followed by brokers and dealers trading on a forward basis in GNMA and FHLMC guaranteed mortgage-backed securities. This "Board" would be composed of representatives of bank and nonbank securities dealers and public representatives, including investors. It would have

authority to set initial margin and margin maintenance requirements for forward transactions in GNMA and FHLMC securities. In addition, if deemed necessary, it could establish financial and fair practice standards and other rules.

The proposed Board would exercise rulemaking authority subject to the oversight of a Council composed of the Secretary of the Treasury, the Chairman of the Federal Reserve Board, and the Chairman of the Securities and Exchange Commission, or their respective designees. The Council would have the power to approve or disapprove the rules of the Board and to abrogate, add to, or delete from such rules. Before taking actions that would affect trading practices in markets for GNMA and FHLMC securities, the Council would be required to request and consider the views of GNMA and FHLMC. Brokers and dealers, including bank dealers, trading in GNMA and FHLMC securities on a forward basis would be required to register with the Council, although the Council would delegate this registration function, in the first instance, to the SEC. Clearing agencies for forward trading in GNMA and FHLMC securities would also be subject to registration and oversight.

Governmental entities other than the Council would also be assigned certain direct rulemaking responsibilities. While the Board's margin setting authority would be exercised under the general review of the Council, the Federal Reserve Board would be given residual rulemaking authority in this area, and any margin rules it might promulgate would take precedence over those of the Board. Also, the SEC would have antifraud rulemaking authority. All nonbank securities dealers trading in GNMA and FHLMC securities on a forward basis, moreover, would be required to become members of the Securities Investors Protection Corporation (SIPC) and subject to its requirements.

To assure compliance with the rules promulgated by the Board, primary inspection and enforcement authority would be allocated to the National Association of Securities Dealers (NASD), national securities exchanges, and the federal bank regulatory agencies, with concurrent enforcement authority in the SEC. This is similar to the division of responsibilities currently followed in ensuring compliance with rules established by the Municipal Securities Rulemaking Board. Thus, such an approach would appear likely to minimize costs associated with such activities for both the government and securities dealers.

It is proposed that the Board be given authority, subject to unanimous approval of the Council, to extend regulatory controls to cash transactions in regulated securities where necessary or appropriate with respect to the regulation of forward transactions. Further, the Council would have the authority, by unanimous vote, to extend regulation to transactions in other government related securities (but not to Treasury securities). While such an extension of federal regulation does not appear to be necessary at the present time--except perhaps to the extent that effective regulation of forward transactions in GNMA and FHLMC securities may require some regulation of the cash markets--the availability of this authority would facilitate such actions, should this be warranted by future developments.

## FIRMS AND ORGANIZATIONS INTERVIEWED

I. Government Securities Dealers
- A.G. Becker, Inc., New York
- Carty & Company, Memphis
- The First Boston Corporation, New York
- Merrill Lynch Government Securities, Inc., New York
- Paine, Webber, Jackson & Curtis, Inc., New York
- Salomon Brothers, Inc., New York

II. Regulatory Agencies
- Arkansas Securities Department
- Bradford Securities Processing Corporation
- Federal Deposit Insurance Corporation
- Federal Home Loan Bank Board
- Federal Home Loan Mortgage Corporation
- Federal National Mortgage Association
- Government National Mortgage Association
- Municipal Securities Rulemaking Board
- National Association of Securities Dealers, Inc.
- National Credit Union Administration
- Office of the Comptroller of the Currency
- Securities Investor Protection Corporation
- Small Business Administration
- Texas Securities Board

III. Mortgage Issuers
- Cameron-Brown Company, Raleigh
- The Lomas & Nettleton Company, New Haven

IV. Trade Associations
- Mortgage-Backed Securities Assocation
- Public Securities Association

V. Investors
- Greater New York Savings Bank, New York
- Several individual investors, Memphis

VI. Others
- Arthur Young & Company, Houston
- Baker & Botts, Houston
- Francis J. Scott, Memphis (Presently co-trustee in bankruptcy for G. Weeks Securities, Inc.)
- Mortgage-Backed Securities Clearing Corporation

# CHAPTER II

## OVERVIEW OF FEDERAL AND FEDERALLY ASSISTED BORROWING IN SECURITIES MARKETS

This chapter provides a brief overview of the major categories of federal and federally-assisted obligations that are exempt from regulation by SEC, their growth over the past decade, and the general trends in the methods of Federal financing in the securities markets. This chapter also discusses the role of the Federal Financing Bank in determining the future development and growth of programs of guaranteed obligations financed directly in the securities markets. A fuller discussion of the characteristics of these securities is presented in Chapter III.

### Classes of Obligations

The market for federal and federally-assisted obligations consists of (1) obligations issued by federal agencies (currently the Treasury is the only federal agency issuing obligations in the market, although a small amount of debt previously issued by other federal agencies remains outstanding in the market), (2) obligations issued by government-sponsored agencies (i.e., federally chartered but privately owned agencies), and (3) obligations guaranteed by federal agencies. These three classes of obligations, which are described below, are referred to in the U.S. Budget documents as "borrowing under federal auspices" or as "federal and federally-assisted borrowings". The amounts of these various obligations outstanding over the past ten years are shown in the tables attached to this chapter.

### SEC Exemption

These federal and federally-assisted obligations, as well as obligations of international financial institutions, such as the International Bank

for Reconstruction and Development, are exempt from regulation by the Securities and Exchange Commission, except for the anti-fraud provisions of the SEC statutes. However, the issuance of federal and federally-assisted obligations is subject to the supervision of federal agencies, other than the SEC, with direct responsibilities to the Congress to provide for the efficient financing of the public debt and of various programs to assist housing, agriculture, small business, education and many other sectors of the economy.

As discussed in Chapter IV, the laws administered by the Securities and Exchange Commission generally exempt from regulation "any security issued or guaranteed by the United States". 1/ Moreover the laws authorize the SEC to exempt either by rule or regulation certain securities, as necessary or appropriate in the public interest or for the protection of investors. Using this authority, the SEC has adopted a rule classifying mortgages and interest in mortgages sold by the Federal Home Loan Mortgage Corporation as exempted securities. 2/ The Securities Exchange Act of 1934 authorizes the Secretary of the Treasury to exempt securities issued or guaranteed by corporations in which the United States has a direct or indirect interest. Under this authority

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1/ See, for example, section 3(a)(2) of the Securities Act of 1933 (15 U.S.C. 77 c(a)(2)), section 3(a)(12) of the Securities Exchange Act of 1934 (15 U.S.C. 78 c(a)(12)), and Section 304(a)(4) of the Trust Indenture Act of 1939 (15 U.S.C. 77 ddd(a)(4)).

2/ Rule 3a12-1, 17 CFR 240.3a12-1. The SEC adopted this rule in light of "the congressionally determined public need for more capital in mortgages, FHLMC's abilities and desire to regulate this field to the extent necessary and the probable lack of small investor participation." 37 Fed. Reg. 25166-67 (Nov. 28, 1972).

the Secretary of the Treasury has designated certain obligations issued by government-sponsored agencies, such as the Federal Land Banks, and the Federal Intermediate Credit Banks, as exempt securities. 3/

In addition to the general exemptions contained in federal securities laws, the charter acts for several federal agencies 4/, federally-sponsored agencies 5/, and international financial institutions 6/ provide that securities issued or guaranteed by these agencies shall be treated as exempt securities.

The exemption of federal and federally-assisted securities from SEC regulation is based in part on the unquestioned integrity of federal agencies and the credit quality of their securities, which eliminates the need for disclosure of information relating to the financial condition of the issuer 7/ and also makes these obligations less subject to abuses in secondary market trading compared to other securities which are more speculative in nature.

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3/ Securities Exchange Act Releases No. 34-14853 (June 27, 1978) (Farm Credit Investment Bonds); 34-13190 (Feb. 1, 1977) (consolidated systemwide bonds); 34-11258 (Feb. 19, 1975) (notes); 34-8829 (May 6, 1970) (Farm Credit Investment bonds).

4/ E.g., Government National Mortgage Association, 12 U.S.C. 1723c; Federal Financing Bank, 12 U.S.C. 2290(b).

5/ E.g., Federal National Mortgage Association, 12 U.S.C. 1719(d), 1723c; Student Loan Marketing Association, 20 U.S.C. 1087-20(1).

6/ E.g., International Bank for Reconstruction and Development, 22 U.S.C. 286K-1(a); Inter-American Development Bank, 22 U.S.C. 283h(a).

7/ Hearings before House Comm. on Interstate and Foreign Commerce on H.R. 7852 and H.R. 8720, 73d Cong., 2d Sess. 818 (1934) (Federal government has "strongest credit of all [issuers]"); Hearings before the House Comm. on Interstate and Foreign Commerce on H.R. 4314, 73d Cong., 1st Sess. 110 (1933) (Federally-issued securities "unquestionably sound").

## Growth of Exempt Securities Markets

The pre-1970 period. Prior to 1970 the exempt government securities markets consisted almost entirely of (1) direct Treasury debt issues under the surveillance of the Treasury and its fiscal agents, the Federal Reserve Banks, and (2) sponsored agency debt issues under the surveillance of the privately-owned issuing agencies (and their federal supervisory agencies): Federal National Mortgage Association (Department of Housing and Urban Development), the Federal Home Loan Banks (Federal Home Loan Bank Board) and the Federal farm credit banks (Farm Credit Administration). These markets were well-established and highly competitive.

While guaranteed obligations prior to 1970 were financed largely by traditional mortgage lenders, rather than in the securities markets, there were several notable exceptions such as the Government National Mortgage Association (GNMA) participation certificates (PCs--not to be confused with GNMA mortgage pass-through certificates) in pools of loans sold in the late 1960's, public housing bonds, Farmers Home Administration notes, and small business investment company (SBIC) debentures. These guaranteed security issues in the market have since been discontinued, not for regulatory reasons, but for budget and debt management reasons. The GNMA participation certificates were discontinued after the adoption of the Unified Budget in 1968, which required that GNMA PCs be treated as a means of financing rather than as asset sales (which reduced budget outlays), the effect of which was to eliminate the immediate budget advantage of PC sales. The marketing of guaranteed securities had resulted in excessive financing costs and competition with direct Treasury issues, and these concerns led to the enactment of the Federal Financing Bank

Act of 1973, which created the Federal Financing Bank ("FFB") and provided for consolidated financing by the Treasury of obligations issued, sold, or guaranteed by federal agencies. Consequently, new issues of guaranteed public housing bonds, SBIC debentures, Farmers Home notes, and certain other guaranteed securities are no longer financed in the market. While the volume of these guaranteed securities issued in the market had been substantial, they were sold mainly by the federal guaranteeing agencies themselves, by means of asset sales and other consolidated financing techniques, and these markets were largely free of reported abuses.

The post-1970 period. The decade of the 1970's was a period of extraordinary growth in federal and federally-assisted borrowing because the Treasury was required to finance a succession of large budget deficits (the last budget surplus was in fiscal year 1969) and off-budget federal credit assistance programs were expanded in virtually all sectors of the economy.

With growing pressures to reduce budget deficits, and as record increases in market rates of interest led to disintermediation and the drying up of traditional sources of mortgage funds, federal agencies turned increasingly to the use of guaranteed securities, rather than direct budget loans, as a means of tapping the bond market to fund their programs. Agency guarantees of obligations issued directly in the securities markets served to by-pass both the Treasury (and thus the budget) and to some extent the financial intermediaries which had traditionally been the main source of funds for many programs.

In the fiscal years 1970-1979, total federal and federally-assisted borrowing from the public increased by $604 billion, from $409 billion outstanding at the end of fiscal 1969 to $1,013 billion outstanding on September 30, 1979

(see table 1). Three fifths of the amount outstanding on September 30, 1979, or $645 billion, was direct federal debt, virtually all in the form of Treasury securities. Federal agencies other than the Treasury (e.g., Tennessee Valley Authority, U.S. Postal Service, and Export-Import Bank) reduced their outstanding borrowings from the public over the period by about $6 billion. These agencies now finance their activities through the FFB.

The outstanding Treasury debt included $64 billion of Treasury issues required to finance the activities of the Federal Financing Bank. As discussed more fully below, in the absence of the FFB, most of these activities would have been financed with a variety of government-guaranteed securities issued directly in the securities markets and, like Treasury securities, would have been exempt from SEC regulation.

Federally-guaranteed borrowing increased from $110 billion in 1970 to $228 billion in 1979, including $70 billion of GNMA guarantees of mortgage-backed securities (see table 2). Over the period, the FFB purchased $47 billion of guaranteed obligations. In fiscal year 1979, GNMA and the FFB accounted for about 80 percent of the net increase in outstanding guaranteed loans.

Borrowing by federally-sponsored agencies increased from $32 billion to $140 billion over the 1970-79 period, largely because of the housing support activities of FNMA and the FHLBB system (see table 3).

## Government-Sponsored Agency Debt

The federally-sponsored credit agencies consist of seven federally chartered but privately-owned agencies which provide credit for agriculture, housing, and education. They are essentially financial intermediaries,

Table 1
OUTSTANDING FEDERAL AND FEDERALLY ASSISTED BORROWING FROM THE PUBLIC
(Fiscal years; billions of dollars)

| | 1970 | 1971 | 1972 | 1973 | 1974 | 1975 | 1976 | 1977 | 1978 | 1979 |
|---|---|---|---|---|---|---|---|---|---|---|
| Federal borrowing | 284.9 | 304.3 | 323.8 | 343.0 | 346.1 | 396.9 | 479.8 | 551.8 | 610.9 | 644.6 |
| FFB holdings of: | | | | | | | | | | |
| Agency debt | -- | -- | -- | -- | 0.5 | 7.0 | 10.0 | 12.3 | 14.3 | 17.1 |
| Guaranteed debt | -- | -- | -- | -- | 0.1 | 6.3 | 12.4 | 23.1 | 33.8 | 47.1 |
| TOTAL FFB 1/ | -- | -- | -- | -- | 0.6 | 13.3 | 22.4 | 35.4 | 48.1 | 64.2 |
| Guaranteed borrowing 2/ | 110.3 | 123.7 | 139.5 | 154.6 | 161.0 | 166.8 | 177.2 | 194.4 | 205.4 | 228.1 |
| GNMA | 0.4 | 3.4 | 6.8 | 9.2 | 12.9 | 17.7 | 25.6 | 42.9 | 53.0 | 70.6 |
| Other | 109.9 | 120.3 | 132.7 | 145.4 | 148.1 | 149.1 | 151.6 | 151.5 | 152.4 | 157.5 |
| Sponsored agency borrowing 3/ | 32.1 | 32.7 | 37.4 | 50.6 | 65.4 | 73.6 | 77.9 | 91.0 | 115.1 | 140.0 |
| Total federal and federally assisted borrowing from the public | 427.3 | 460.8 | 500.7 | 548.3 | 572.5 | 637.3 | 735.0 | 837.3 | 931.5 | 1,012.7 |

Office of the Secretary of the Treasury, Office of Government Financing March 28, 1980

1/ The Federal Financing Bank borrows from the Treasury, which increases the amount of Treasury (federal) borrowing from the public.

2/ Excludes guaranteed borrowing from sponsored agencies and from the FFB and other federal agencies. See table 3 for details.

3/ Excludes sponsored agency holdings of federal and sponsored agency obligations, and federal loans to sponsored agencies. See table 4 for details.

NOTE: Figures may not add to totals due to rounding.

Table 2
OUTSTANDING FEDERALLY GUARANTEED BORROWING
(Fiscal years; billions of dollars)

| | 1970 | 1971 | 1972 | 1973 | 1974 | 1975 | 1976 | 1977 | 1978 | 1979 |
|---|---|---|---|---|---|---|---|---|---|---|
| Funds appropriated to the President | | | | | | | | | | |
| Military Assist./ Int'l Security Assistance | 0.4 | 0.4 | 0.3 | 0.2 | 0.3 | 1.0 | 2.3 | 4.0 | 4.5 | 5.7 |
| Economic Assist./ Int'l Dev. Assistance | 0.2 | 0.2 | 0.5 | 0.5 | 0.5 | 0.6 | 0.2 | 0.8 | 0.8 | 0.9 |
| Agriculture Farmers, Home Administration | 5.0 | 5.4 | 6.9 | 9.4 | 9.8 | 14.9 | 17.8 | 21.9 | 28.2 | 37.1 |
| Commodity Credit Corporation | -- | -- | -- | -- | -- | -- | -- | -- | -- | 0.1 |
| Rural Elect. Administration | -- | -- | -- | -- | -- | 0.3 | 1.1 | 2.9 | 4.8 | 7.5 |
| Commerce | 0.6 | 0.9 | 1.1 | 1.3 | 1.7 | 2.4 | 3.6 | 4.9 | 5.5 | 6.7 |
| Health, Education & Welfare | 2.0 | 2.6 | 3.8 | 4.8 | 6.7 | 7.7 | 7.9 | 9.5 | 10.4 | 12.4 |
| Housing & Urban Dev. | | | | | | | | | | |
| FHA | 67.6 | 77.2 | 85.0 | 86.9 | 85.3 | 85.4 | 89.0 | 93.8 | 98.1 | 110.1 |
| GNMA | 0.4 | 3.4 | 6.8 | 9.2 | 12.9 | 17.7 | 25.6 | 42.9 | 53.0 | 70.6 |
| Public housing | 8.1 | 9.5 | 10.7 | 11.8 | 12.4 | 13.2 | 13.6 | 14.2 | 14.6 | 15.1 |
| Other | 3.0 | 3.3 | 4.0 | 4.6 | 4.9 | 4.4 | 3.3 | 1.9 | 0.9 | 0.6 |
| Veterans Admin. | 36.0 | 37.6 | 42.0 | 47.2 | 52.9 | 58.0 | 64.1 | 71.9 | 80.8 | 89.2 |
| Export-Import Bank | 1.2 | 1.5 | 2.1 | 2.7 | 3.4 | 4.5 | 5.3 | 5.3 | 5.4 | 6.6 |
| Small Bus. Admin. | 0.8 | 1.0 | 2.0 | 3.1 | 4.0 | 4.1 | 5.0 | 5.8 | 7.7 | 8.5 |
| Other | 0.2 | 0.5 | 0.4 | 1.6 | 2.3 | 4.3 | 4.3 | 4.4 | 2.6 | 16.1 |
| TOTAL, Gross | 125.5 | 143.5 | 165.7 | 183.3 | 197.2 | 218.3 | 243.2 | 284.3 | 317.3 | 387.2 |
| Less adjustments 1/ | 15.2 | 19.8 | 26.2 | 28.7 | 36.2 | 51.5 | 66.0 | 89.9 | 119.9 | 159.1 |
| TOTAL NET GUARANTEES | 110.3 | 123.7 | 139.5 | 154.6 | 161.0 | 166.8 | 177.2 | 194.4 | 205.4 | 228.1 |

1/ Excludes guarantees of guarantees and guaranteed loans held as direct loans by federal and sponsored agencies.

Table 3
OUTSTANDING SPONSORED AGENCY BORROWING
(Fiscal years; billions of dollars)

| | 1970 | 1971 | 1972 | 1973 | 1974 | 1975 | 1976 | 1977 | 1978 | 1979 |
|---|---|---|---|---|---|---|---|---|---|---|
| Education: Student Loan Marketing Association | -- | -- | -- | -- | 0.3 | 0.2 | 0.4 | 0.5 | 0.7 | 1.3 |
| Housing and Urban Dev.: | | | | | | | | | | |
| Federal National Mortgage Association | 13.2 | 15.0 | 18.5 | 20.4 | 25.2 | 28.2 | 29.9 | 31.5 | 38.3 | 46.0 |
| Farm Credit Administration: | | | | | | | | | | |
| Banks for Cooperatives | 1.6 | 1.8 | 1.8 | 2.4 | 2.6 | 3.2 | 4.2 | 5.0 | 5.8 | 6.8 |
| Federal Intermediate Credit Banks | 5.0 | 5.7 | 6.2 | 6.7 | 8.1 | 9.6 | 10.6 | 12.7 | 13.1 | 15.8 |
| Federal Land Banks | 6.3 | 6.8 | 7.6 | 9.1 | 11.2 | 14.2 | 16.3 | 19.5 | 22.3 | 27.2 |
| Federal Home Loan Bank Board: | | | | | | | | | | |
| Federal Home Loan Banks | 9.9 | 7.3 | 6.5 | 10.2 | 16.7 | 20.6 | 18.7 | 17.2 | 25.0 | 30.1 |
| Federal Home Loan Mortgage Corporation | 0.8 | 1.4 | 2.4 | 3.0 | 4.1 | 6.3 | 7.7 | 8.6 | 13.8 | 18.4 |
| TOTAL, Gross | 36.6 | 38.1 | 43.1 | 51.9 | 68.0 | 82.3 | 87.7 | 95.0 | 118.9 | 145.6 |
| Less adjustments 1/ | 4.5 | 5.4 | 5.7 | 1.3 | 2.6 | 8.7 | 9.8 | 4.0 | 3.8 | 5.6 |
| TOTAL NET BORROWING | 32.1 | 32.7 | 37.4 | 50.6 | 65.4 | 73.6 | 77.9 | 91.0 | 115.1 | 140.0 |

1/ Sponsored agency holdings of federal and sponsored agency obligations, and federal loans to sponsored agencies.

borrowing in the securities market and relending the borrowed funds for specifically authorized purposes.

The agricultural credit agencies are the Federal Land Banks, created in 1916; the Federal Intermediate Credit Banks, established in 1923; and the Banks for Cooperatives, created in 1933. Serving the housing sector is the Federal Home Loan Bank System, created in 1932, its wholly-owned subsidiary, the Federal Home Loan Mortgage Corporation (FHLMC) created in 1970, and the Federal National Mortgage Association (FNMA), initially established in 1938 and restructured in 1954 and 1968. The Student Loan Marketing Association (SLMA), created pursuant to 1972 legislation, provides secondary market support for guaranteed student loans.

Obligations of these government-sponsored agencies are issued with the approval of or in consultation with the Treasury. Also, in the case of the Federal Home Loan Banks and FNMA, the Secretary of the Treasury is authorized to lend up to $4 billion and $2.25 billion, respectively, to these institutions. Yet the law specifies that their obligations are not obligations of the United States, and they are not guaranteed by the government except for certain mortgage-backed bonds issued by FNMA and FHLMC and guaranteed by the Government National Mortgage Association. (Obligations of SLMA are guaranteed by HEW, but SLMA borrows exclusively from the FFB.) Nevertheless, sponsored agency obligations enjoy an excellent standing in the credit markets because of the long record of successful operations by these agencies and their close association with the government.

Federally-sponsored agency obligations share many of the characteristics of Treasury securities. For example, they are:

-- Lawful investments and may be accepted as security for all fiduciary, trust and public funds, including Treasury tax and loan accounts, the investment or deposit of which is under the authority of any officer of the United States.

-- Eligible for Federal Reserve Bank open market purchases.

-- Eligible as collateral for Federal Reserve Bank advances to member banks.

-- Eligible for purchase by national banks without restriction.

-- Eligible for investment by federally-chartered savings and loan associations and federally-chartered credit unions.

## Government-Guaranteed Debt

In addition to providing credit through the vehicle of the government-sponsored credit agencies, the Federal Government also provides credit assistance in the form of direct loans made by Federal agencies and financed by the Treasury or by the FFB and agency guarantees of loans financed by the FFB or other lenders.

The original loan guarantee programs were not financed in the securities markets. The federal government guaranteed mortgages and other loans made by local lending institutions which serviced the loans through direct contact with the borrowers and generally assumed a portion of the loan risk. The classic example of this guarantee approach was the highly successful program of FHA single family mortgage insurance. This program assured private lenders

that they could safely make long-term, low down payment mortgage loans at reasonable rates of interest, thus filling an important credit gap. Since establishment of the FHA in the 1930's, the guarantee technique has been expanded to provide credit assistance to a wide variety of housing and other areas such as agriculture, education, economic development, export financing, small business, transportation, and energy.

Shift to securities market financing. Prior to 1973, a number of trends fostered the development of direct securities market financing of guaranteed loans:

-- A broadening of the guarantee instrument from the direct mortgage insurance provided by FHA to such indirect but equally effective guarantees as purchase and lease agreements, contracts to make debt service grants, price support agreements or commitments by Federal agencies to make direct take out loans in the event of default on a private obligation. These and other arrangements have been used to provide federal backing for securities market issues, they are included in the definition of guaranteed obligations in the Federal Financing Bank Act of 1973, and they are generally classified as guaranteed obligations in the Budget of the United States.

-- A reduction in private lender participation in risk assumption as full guarantees of principal and interest became widespread.

-- A shift away from direct government loans to guaranteed loans financed in the market in part to escape the budget discipline.

-- Reduced reliance on local private lenders in favor of direct agency debt (Eximbank), sale of agency assets in the form of certificates of beneficial ownership (Farmers Home Adminisration), loan pooling arrangements (Farmers Home Administration, SBA and other loans), and by federal guarantees of other securities (GNMA mortage-backed securities, public housing and urban renewal notes and bonds, WMATA bonds, new community debentures, and merchant marine bonds).

This shift to bond market financing had grown to such extent that by the time the Federal Financing Bank Act was enacted in 1973 some form of Federal or federally-assisted financing was coming to market on three out of every five business days.

Creation of the FFB. The proliferation of federal and federally-guaranteed obligations financed directly in the securities markets led to market congestion and higher borrowing costs. Borrowing costs on federally-backed credit other than Treasury obligations, that is, agency securities and federally-guaranteed private issues, are higher because of the small size of issues, maturity and cash flow constraints, problems in developing markets for new issues, investor portfolio restrictions, underwriting costs, and market congestion resulting from crowding of competing issues in the financing calendar. Additional costs were incurred because agencies that were selling securities directly in the market were required to develop their own financing staffs to cope with complex debt management and regulatory problems that diverted resources away from principal program functions.

Creation of the FFB substantially alleviated these problems. At the close of fiscal year 1979, the FFB held $64 billion of federal agency and federally-guaranteed obligations, most of which would have been sold directly in the securities market in the absence of the FFB. Because of the FFB, the growth of the guaranteed securities market, other than GNMAs, was sharply curtailed. In the four years prior to the establishment of the FFB, these guaranteed obligations increased by $38 billion, from $110 billion in 1970 to $148 billion in 1974. In the next four years these obligations increased by only $4 billion, to $152 billion in 1978 (see table 1). The $5 billion further increase in 1979 was largely in the form of Export-Import Bank and student loan guarantees, with minor increases in a number of other guaranteed loan programs.

Consequently, the $39 billion net financing requirements for loan guarantees in fiscal year 1979 was largely financed in the Treasury and GNMA markets. That is, $13.3 billion was financed through the Federal Financing Bank, and thus by the Treasury, and $17.6 billion was financed by GNMA mortage-backed securities (see table 4). In addition, several smaller guarantee programs were financed directly in the securities markets, including public housing notes ($.5 billion), merchant marine bonds ($.3 billion) and partial guarantee programs of the Farmers Home Administration and the Small Business Administration under which the lending bank sells the 90 percent guaranteed portion in the securities market and retains the 10 percent unguaranteed portion. These smaller programs are eligible for FFB financing.

Table 4
NET CHANGE IN FEDERAL AND FEDERALLY ASSISTED BORROWING FROM THE PUBLIC
(Fiscal years; billions of dollars)

| | 1970 | 1971 | 1972 | 1973 | 1974 | 1975 | 1976 | 1977 | 1978 | 1979 |
|---|---|---|---|---|---|---|---|---|---|---|
| Federal borrowing | 5.4 | 19.4 | 19.4 | 19.3 | 3.0 | 50.9 | 82.9 | 53.5 | 59.1 | 33.6 |
| FFB holdings of: | | | | | | | | | | |
| Agency debt | -- | -- | -- | -- | 0.5 | 6.5 | 3.0 | 1.4 | 2.0 | 2.9 |
| Guaranteed debt | -- | -- | -- | -- | 0.1 | 6.2 | 6.1 | 8.1 | 10.7 | 13.3 |
| TOTAL FFB 1/ | -- | -- | -- | -- | 0.6 | 12.7 | 9.1 | 9.5 | 12.7 | 16.1 |
| Guaranteed borrowing 2/ | 2.6 | 13.4 | 15.8 | 15.1 | 6.4 | 5.8 | 10.4 | 14.6 | 11.0 | 22.7 |
| GNMA | 0.4 | 3.0 | 3.4 | 2.4 | 3.7 | 4.8 | 7.9 | 15.4 | 10.0 | 17.6 |
| Other | 2.2 | 10.4 | 12.4 | 12.7 | 2.7 | 1.0 | 2.5 | -0.8 | 1.0 | 5.1 |
| Sponsored agency borrowing 3/ | 10.3 | 0.5 | 4.7 | 13.2 | 14.8 | 8.2 | 4.3 | 11.4 | 24.1 | 24.9 |
| Total federal and federally assisted borrowing from the public | 18.3 | 33.4 | 40.0 | 47.6 | 24.2 | 64.8 | 97.7 | 79.5 | 94.2 | 81.2 |

Office of the Secretary of the Treasury, Office of Government Financing — March 28, 1980

1/ The Federal Financing Bank borrows from the Treasury, which increases the amount of Treasury (federal) borrowing from the public.

2/ Excludes guaranteed borrowing from sponsored agencies and from the FFB and other federal agencies. See table 3 for details.

3/ Excludes sponsored agency holdings of federal and sponsored agency obligations, and federal loans to sponsored agencies. See table 4 for details.

NOTE: Figures may not add to totals due to rounding.

Consequently, except for GNMAs, government-guaranteed obligations are now only a minor portion of the newly issued exempted securities. Whether they become a significant factor will depend largely on the extent to which guaranteed securities are marketed directly or purchased by the Federal Financing Bank.

# CHAPTER III

# REVIEW OF MAJOR CHARACTERISTICS OF MARKETS FOR GOVERNMENT RELATED SECURITIES

The characteristics of instruments, participants and trading practices in markets for federally related securities are reviewed below. Attention is first directed to the U.S. Treasury market and then, in turn, to markets for federally sponsored agency securities, federally guaranteed mortgage-backed securities, and other obligations guaranteed by various federal agencies. 1/ A final section briefly reviews markets for securities of government-sponsored international organizations.

Federally guaranteed mortgage-backed securities receive particular attention in the discussion because these instruments account for the largest volume of actively-traded, guaranteed debt. Moreover, unlike other sectors of the government-related securities market, a substantial proportion of trading in mortgage-backed securities is done on a long delayed delivery basis, and it is here that most of the problems in these markets have arisen. The trading of contracts for long forward delivery is a natural consequence of the underlying cycle of loan production inherent to the mortgage market. This process is discussed in some detail in the section that reviews GNMA securities.

## U.S. Treasury Securities

### Instruments and Method of Issuance

The Treasury issues marketable debt in all areas of the maturity spectrum in order to attract the widest possible range of investors while meeting the objective of maintaining an overall debt structure consistent

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1/ The five appendices at the end of this chapter provide more detail on each of these major sectors of the government-related securities market.

with sound financial practice. In 1979, for example, the Treasury sold a total of $464 billion of new marketable obligations to help finance the federal budget deficit, Treasury loans to the Federal Financing Bank and to refinance maturing debt. Of this total, about $370 billion of securities were issued in the form of Treasury bills with maturity dates of about 2 weeks to 52 weeks. The remainder consisted of longer-term coupon obligations (notes and bonds) with maturities ranging from 2 years to 30 years. Given the substantial volume of its financing needs, the Treasury conducted at least one financing operation in each week of the past year and in a number of weeks came to the market with 3 or 4 offerings.

In the past the Treasury used a number of techniques to sell its debt, but in recent years has relied exclusively on competitive auctions. The Treasury announces these auctions in advance--from 1 to about 10 days ahead--indicating the type and amount of securities to be sold as well as terms and conditions to be met by those wishing to bid in the auction. In general, any institution or person is eligible to submit competitive bids in these auctions, if they are willing to take a volume of issues above a specified minimum and meet other conditions set by the Treasury. 2/

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2/ Competitive bids for notes and bonds have usually been submitted on a yield basis--that is, the bidder specifies the yield at which he is willing to acquire a given volume of issues--and the Treasury then makes awards by accepting bids starting with the lowest yield bid submitted. Bids for bills are submitted on the basis of a discount from par. It is also possible for investors to participate in the auction on a noncompetitive basis, if they are willing to submit bids for quantities below a specified amount. Noncompetitive bids are always awarded in full at a yield equal to the average rate set in the competitive auction. The Federal Reserve and foreign official accounts also bid on a noncompetitive basis. On some occasions, the Federal Reserve also submits competitive bids in these auctions.

While a sizable share of the issues offered in an auction is sold directly to final investors, there are many dealer firms of various size throughout the country that acquire securities in the auctions and then distribute them to final investors. The great proportion of such activity is undertaken by primary dealers in U.S. Treasury securities, firms that submit daily reports for the review of the Federal Reserve and U.S. Treasury and are subject to surveillance by these agencies.

Trading Activity

In addition to taking and distributing securities awarded in Treasury auctions, dealer firms also make secondary markets in Treasury securities as well as in other government related securities, by standing ready to purchase or sell these instruments from their own positions. Spreads between bid and asked prices quoted by dealers are ordinarily quite narrow. Banks and other major financial and nonfinancial firms have traditionally used the Treasury securities market as a means of making adjustments in liquidity positions and realigning investment portfolios. Thus, with this trading activity plus substantial trading among dealers, the daily volume of outright transactions in the U.S. Treasury securities averaged about $13 billion in 1979; this compares with an average daily trading volume on the New York Stock Exchange (which accounts for about 85 percent of the dollar value of all trading of stocks in the U.S.) of about $1 billion.

Essentially all trading in outstanding Treasury issues is done on a cash (same day) delivery basis or regular (next business day) delivery basis. There is also a substantial volume of "when issued" trading of securities that takes place between the time a security has been auctioned and the time it is

issued. Parties to these trades agree to buy or sell a given amount of the security at a specified price on the day the security is issued. 3/

A substantial volume of trading in contracts for future delivery of Treasury securities also occurs on a number of the commodity futures exchanges. These futures contracts call for the delivery of a specified volume of designated Treasury securities on a particular date in the future. Currently, there are contracts being traded that specify the delivery of Treasury bills, short- to intermediate-term Treasury notes, and long-term Treasury bonds. 4/

U.S. Treasury securities have also been purchased and sold on a forward (or delayed) delivery basis. Such transactions are similar to futures contracts in that delivery of a given amount of a designated security is specified for some date in the future. These terms are not standardized, however, as they are in futures contracts; and trades are negotiated between parties on an over-the-counter basis rather than effected in a centralized exchange. There appears to be little, if any, forward trading in U.S. Treasury securities at the present time. 5/

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3/ The when-issued period generally ranges from a few days in length in the case of cash management bills and 3- and 6-month Treasury bills to about a calendar week in the case of notes and bonds sold in the Treasury's 4 quarterly refunding operations.

4/ For a detailed discussion of Treasury futures, see the Treasury/Federal Reserve Study of Treasury Futures Markets published in May 1979.

5/ The major volume of forward trades in Treasury securities appears to have taken place in the period before May 1978. In that period, a number of municipalities issued term bonds and set up sinking funds to accumulate revenues that would eventually be used to repay these bonds. To obtain a known return on the sinking fund, these governmental entities purchased Treasury securities forward from dealers, thus "locking in" a certain return that exceeded the interest costs on the term bonds. The Treasury changed its regulations in May 1978 to eliminate the economic advantages of these arrangements.

## Investors

Because Treasury securities are free of default risk and highly liquid, they are in broad demand by the investing public. The Treasury's latest survey indicates that of the roughly $410 billion of marketable debt held by private investors, commercial bank holdings account for the largest proportion of the total--about one-fourth. In addition, insurance companies, other financial institutions, nonfinancial corporations, state and local governments and pension funds have large holdings. Individuals also own a sizable share of the total.

## Repos

The market for repurchase agreements (repos) and reverse repurchase agreements (reverse repos) was originated as an adjunct of the Treasury securities market and still is primarily associated with this market. These agreements involve the sale (purchase) of a security coupled with a promise to repurchase (resell) the security at a later date. (By convention the party initially selling the security is said to be arranging a repurchase agreement.) Repos were developed by U.S. Treasury security dealers to provide an alternative source of funds to finance their security positions. Parties initially providing this financing--mainly financial institutions, nonfinancial corporations and pension funds--were attracted to these arrangements because they provided a ready means to invest money on a short-term basis in great safety.

Over the years the repo market has grown and developed in a number of ways. Dealers now use the market as the principal financing source for their positions. Indeed, the types of securities used in this method of financing

have expanded to include federally sponsored agency issues, government-guaranteed mortgage-backed securities, negotiable CDs of banks, bankers' acceptances and other securities. Dealers also have become important intermediaries in the market, arranging repos with one set of customers and reverse repos with others. These "matched book" transactions, which transfer funds from economic units with a surplus to those with a shortage, now substantially exceed the volume of repos dealers arrange to finance their own positions.

Repurchase agreements initially were arranged on an overnight (or over-the-weekend) basis, and this remains the predominant maturity of such contracts. In recent years, however, a sizable volume of such transactions have had longer contract periods--ordinarily periods of 1 to 3 months, but in some cases apparently 5 or 6 months. The contracts, therefore, are now being used to satisfy borrowing and investing strategies designed to achieve longer-run objectives as well as for the day-to-day management of funds.

Thrift institutions and other financial firms with GNMA security portfolios have been using repos and particularly term repos in recent years as a means of obtaining funds to meet short-term liquidity needs. Such transactions are sometimes arranged in the form of classic repo agreements--that is, a GNMA with a given pool number (which identifies the specific pool of mortgages from which payments of principal and interest are passed through to the security holder) is sold to a dealer under an agreement which specifies that a GNMA security with the same pool number will be repurchased on a later date. Recently, an alternative form of repo agreement has been developed that is commonly referred to as a "dollar price repo." Under these contracts, it is

agreed that when the thrift repurchases from the dealer, the dealer need not--and in practice usually does not--sell back GNMAs with the same pool number as those originally sold to him. Depending on contract terms, he may redeliver any GNMA issue that has the same coupon as those originally sold or alternatively that provides the same yield to maturity (adjusted for the terms of the repo).

This new type of agreement was developed because dealers ordinarily resold securities they acquired under conventional repo agreements (perhaps on an outright basis, perhaps under repo with no requirement to return the same security) and often found it difficult to obtain GNMAs with the same pool number when it came time to redeliver to the thrift institution. In addition the dollar price repo fits well with the arrangements by which GNMAs are traded on both a cash and forward delivery basis. A dealer will generally quote bid and asked prices for GNMAs with a given coupon for delivery immediately and on various forward dates. (The forward quotes are for GNMAs with a given coupon rate but no pool number is specified.) Thus, in entering into a dollar price repo, the thrift sells GNMAs to the dealer at the dealer's quoted bid price for immediate delivery and simultaneously buys (repurchases) GNMAs for delivery in a future month at the dealer's asked price. The difference between the immediate bid price paid by the dealer and the forward asked price ultimately paid by the thrift in effect represents the amount of interest paid by the thrift for the use of funds over the period until delivery is made under the forward contract.

There are issues raised with regard to the accounting treatment of a dollar price repo relating to whether the investor is required to book a gain

or loss on the transaction. 6/ The thrift institutions' exposure to interest rate risk under such agreements, however, is essentially the same as under a classic repo; under either alternative the capital loss incurred if interest rates rise would be essentially the same. 7/

With the expansion of repo trading in recent years, the greatly increased number of repo customers and the introduction of term contracts, a number of problem cases have developed in which one contracting party was unable to fulfill the terms of the contract. Partly for this reason, many of the people interviewed as part of this study indicated that participants have been applying tighter standards in arranging repo contracts. These traders have made greater efforts to ensure that securities involved in the transaction are initially valued at market and that their value exceeds the amount of money exchanged. They have also included provisions in repo agreements requiring the borrowing party to increase the amount of collateral in the event of erosion in the value of the securities. The borrowing party,

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6/ These transactions raise the obvious issue whether they should be viewed just as regular repos, i.e., accounted for as loans, or instead as outright sales of securities followed by outright purchases. This question is important, of course, because it raises the further issue whether a loss should be shown by the institution when the price it receives when selling is below the book value of the security. Or if a loss is not booked, there is the question of how the transactions should be reflected on the balance sheet of the institution. While there are arguments that can be made on both sides of this question, the Federal Home Loan Bank Board has given approval for S&Ls to treat these transactions as repos, so long as the GNMAs (re)purchased for forward delivery have the same coupon as those sold for immediate delivery.

7/ The prices of GNMAs with the same coupon but different underlying pools do not necessarily move in exact unison with a given change in the general level of rates. Thus, the gain (or loss) from these alternative positions could differ somewhat.

of course, assumes the risk that the securities may not be returned, which would prove costly if securities prices rise.

## Government-Sponsored Agency Securities

### Instruments and Method of Issuance

The sponsored federal agencies finance their operations principally through the sale of debt instruments in the open market. The Farm Credit Agencies (FCA) account for 35 percent of this total; Federal National Mortgage Association (FNMA) 32 percent; and the Federal Home Loan Banks (FHLB) 33 percent. 8/ In 1979, the sponsored agencies issued on a gross basis $117 billion of debt to rollover maturing debt and raise new money. This resulted in a net increase in indebtedness of $25-1/2 billion for the year. Of the total volume of securities sold, 36 percent was issued with an original maturity of less than one year, 60 percent with maturities of 1 to 10 years, and 4 percent with maturities greater than 10 years.

Each of the sponsored agencies employs a fiscal agent to market its debt. The fiscal agents maintain close contacts with the financial community and carefully monitor developments and conditions in financial markets. Based on market conditions and consultations with dealers in the selling groups, the fiscal agents decide on the size, price, maturity and timing of a new debt offering. These decisions are subject to approval by the agency involved, and, because of law or custom, to clearance by the U.S. Treasury. Intermediate- and longer-term securities are offered through large, nationwide selling groups of

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8/ Debt issued and guaranteed by the Federal Home Loan Mortgage Corporation, a wholly owned subsidiary of the Federal Home Loan Bank System, is discussed in a separate section below.

dealers and commercial banks. For sales of short-term discount notes, the agencies rely on a few major money center dealers who continually make a market in agency securities.

Distribution of sponsored agency issues is accomplished in a short period. The time between announcement of terms and allotments to members of the selling group runs no more than a few days. Following the allotments, dealers are expected to distribute the issues to final investors in a short time--in the course of a week or two. Indeed, dealers are expected to have a major share of their allotments presold, and they are either precluded from taking allotments for their own account or are carefully controlled in the amount that they take. All of the issuing agencies carefully monitor the activities of their dealers and have the option, if given cause, to terminate an agreement at any time.

## Trading Activity

Sponsored agency securities generally are traded actively in secondary markets. Average daily trading volume in all issues was above $2.5 billion in 1979. These transactions are almost entirely arranged on either a cash delivery or regular delivery basis. A few transactions have somewhat longer delayed delivery dates, but in few if any cases is the time span longer than a week.

## Ownership

Ownership of federal agency securities is widely dispersed, with commercial banks holding the largest share of the total. Sizable amounts are also held by all other major types of financial institutions, by nonfinancial corporations and by the general funds, pension and retirement funds of states

and localities. The Federal Reserve also is authorized to purchase these securities in the course of its open market operations and currently holds outright about $8.2 billion. Certain Treasury trust funds also hold a small proportion.

## Government-Guaranteed Securities

### GNMA Pass-Through Certificates

Government National Mortgage Association pass-through certificates (GNMAs) provide their holders with an interest in the income stream from specific pools of government-guaranteed (mainly FHA/VA single family) mortgages bearing the same interest rate and with the same maturity. The security holders receive pass-through payments of interest and principal made on the mortgages. The instruments have stated maturities equal to those on the underlying mortgages, usually 25 to 30 years. Because of prepayments, most of the mortgages are repaid in a much shorter period; thus the principal amount outstanding on pass-through certificates is repaid at an accelerated rate, especially in the initial years. By convention based on experience, yields on new securities are quoted on a 12-year maturity basis. While all the mortgages in the pools backing the securities are guaranteed by the federal government, the attractiveness of GNMAs is enhanced by a further guarantee which commits the full faith and credit of the United States government for the timely payment of interest and principal.

### Issuers and Dealers

While authorized and guaranteed by GNMA, GNMA pass-throughs are currently issued by about 900 private firms that originate mortgages. About two-thirds of these firms are mortgage bankers; commercial banks and savings and

loan associations account for most of the remainder. Originators sometimes place newly issued securities directly with final investors, but the great proportion are sold to dealers who then resell them to final investors. There are approximately 20 major dealer firms that account for most of the distribution and trading of GNMAs, but it is estimated that about 60 firms over the country make a market in these securities.

## Investors

Thrift institutions were by far the largest investors in GNMA pass-throughs when they were first issued in 1970. In recent years, however, the investor base for GNMAs has been broadened substantially. Mutual savings banks, commercial banks, pension funds, and state and local governments have become important acquirers of these instruments. In addition, credit unions and individuals each hold significant amounts. It is now estimated by GNMA that about 75 percent of the total issues outstanding (about $85 billion) are held by lenders other than S&Ls.

## Origination and Trading Arrangements

GNMA securities are traded on a regular delivery basis (for the GNMA market this generally implies delivery specified within 30 days) 9/ and on a delayed delivery or forward basis. The former involves trades of outstanding issues as well as sales of newly issued pass-throughs. Trading on a forward basis (between issuers and dealers, among dealers, and between dealers and

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9/ The length of "regular delivery" time is longer for GNMA than for other securities because of technical factors associated with the collection and pass-through of principal and interest.

investors) involves the purchase and sale of securities for delivery often 3 or 4 months in the future and in some cases as much as a year or more. There are two types of forwards, those calling for mandatory delivery on a specified forward date and those with an optional delivery before a specified date (standbys). The trading volume in forward contracts, particularly mandatory delivery contracts, is substantially greater than that which occurs on a regular delivery basis. Most of this trading occurs among the dealer firms, but permanent investors and mortgage originators also trade forward contracts in efforts to improve yields on portfolio positions or in some cases to profit from expected movements in market prices.

Trading on both a regular delivery and forward delivery basis is done on an "over-the-counter" basis with dealers standing ready to add to their position (or sell from their position) at quoted bid and asked prices. Traditionally, a dealer that contracts to buy GNMAs from one dealer on a forward basis and contracts to resell them to another on the same basis has, on the settlement date of these contracts, taken delivery of the obligation from one and made delivery to the other. In many cases, of course, there is a long series of matching forward trades each of which requires physical delivery of the security to complete the transaction. Recently a clearing corporation has been established to faciliate the completion of transactions. The corporation now clears a proportion of its members' trades by matching long and short positions of each member in a given contract and then requesting that a check or securities be delivered to make up the difference. 10/

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10/ For additional discussion of the clearing corporation see page 67 of Appendix C.

Mortgage production cycle and the management of interest rate risk. While accurate statistics are not available on the total volume of trading activity in GNMA securities, it was estimated by some participants interviewed in connection with this study that the average volume of trades per business day might run to about $2.5 billion. As noted above, a large proportion occurs in the form of transactions for forward delivery. Such heavy forward trading in the over-the-counter market for fixed income securities is esentially confined to the market for mortgage-backed securities. It is thus appropriate to focus on the basic reasons for this trading process in order to provide background for discussion in later chapters.

There are fundamental economic reasons for forward transactions in GNMA securities. Mortgage loan commitments, extending months into the future, are essential to the financing of real estate. Contracts for the sale of existing properties usually require buyers to secure mortgage commitments from lenders several months prior to the time the property is transferred and the mortgage loan is closed. Advance commitments also are essential for the construction and sale of new properties. Before making a construction loan, institutions ordinarily require developers to arrange commitments for permanent mortgage financing; in fact, the permanent mortgage commitment usually forms the basis for the construction loan commitment. The production periods for single-family structures typically range between 3 and 6 months--although periods as long as a year are not uncommon--and the production periods for multifamily structures are even longer.

Commitments may specify a rate of interest, or the funds may be committed at a rate to be determined at a time of loan closing. While take-

down of the funds by the buyer is optional under these arrangements, the mortgage originator is firmly committed to provide funds. Thus, buyers may walk away from the contract if interest rates fall relative to rates specified in the contract. The loan originator, on the other hand, when committed to provide funds at a specified rate, must do so even if mortgage rates have risen well above this level.

Those committing to make mortgages, in effect, enter into a kind of forward agreement with a builder or with a buyer of a home or other properties. The committing party then must decide whether to "carry" this commitment risk without hedge or to enter into an agreement in which another party agrees to buy the mortgage at the time it is made. Some parties that commit to make mortgages are also mortgage investors (such as thrift institutions) who will ordinarily take these loans into their own portfolio. Accounting conventions allow institutions to enter mortgages so acquired at par on their books, even if at the time of closing they technically have a market value below par because interest rates have risen above the rate specified in the mortgage. Given that the institution can generally also count on cash flow to make the mortgage, it is, in a sense, screened from the interest rate risk associated with entering into forward mortgage commitments. A substantial volume of mortgage commitments, however, are also originated by mortgage bankers--or by thrifts in excess of their prospective cash flow--who do not intend to hold them in portfolio permanently. In these cases, originators must decide whether to remain exposed to the risk of loss if market rates rise (relative to a commitment rate) or the opportunity to profit if rates should fall, or to hedge their exposure to rate fluctuation. The originator has traditionally obtained such a hedge by arranging

to sell the mortgage once its has been consummated at a specified price to a final investor.

From this perspective it can be seen that the forward market for GNMAs is the natural outgrowth of the mortgage production cycle. A mortgage originator who has committed to make a large block of FHA or VA mortgages or who expects to enter into commitments to make such loans over the near future may sell GNMA securities for forward delivery to a dealer rather than sell these mortgages directly (for forward delivery) to a lending institution.

In addition to selling forward to hedge against the interest rate risk associated with fixed rate commitments, mortgage originators also incur similar risks when they are in the process of accumulating FHA/VA mortgages to be placed in a pool to back a GNMA security. Mortgage bankers and other originators finance these mortgages by borrowing on a short-term basis and thus are exposed to the risk that interest rates may rise over the assembly period, causing a decline in the value of mortgages in the inventory. A forward sale of GNMA securities provides a hedge against this risk by locking in a certain price to be received.

Alternative to selling GNMAs forward for mandatory delivery, mortgage originators also can sell forward on an optional delivery basis. In these "standby" agreements, dealers obtain a fee for agreeing to purchase a given volume of GNMAs at a given yield at a specified future date, if the securities are tendered to the dealer. (These standby agreements are essentially the same type of commitment FNMA sells in its auction of contracts for delivery (at the option of the buyer) of whole FHA/VA mortgages.) The dealers, in turn, depending upon their willingness and ability to carry interest rate risk, will lay off all or a part of this risk by making similar standby agreements with various kinds of

financial firms. For investors who have the financial resources and sophistication to understand the nature of such agreements and their risk exposure, and to negotiate attractive terms--in the form of fees, specified interest rate, etc.--issuance of standbys can be a sound, potentially profitable activity that facilitates the mortgage production and distribution process.

Interest rate risk associated with mortgage production and distribution also can be managed by taking positions in the futures markets for GNMAs. 11/ For example, an originator accumulating a pool of mortgages can sell (go "short" in) a futures contract, a position in which he is assured of receiving a known price for delivering a given volume of GNMA securities on a future date. Thus, he is hedged against the risk that mortgage rates may rise above the rates on the mortgages he holds in portfolio or above the rates at which he is committed to make mortgages. He may choose ultimately to deliver these securities, receiving the price which he "locked in" with his futures contract. Typically, however, he will close out his contract position sometime before it matures. He can achieve such a closeout by buying in the same contract. Such an approach provides a good hedge, because if mortgage rates rise over the holding period, the price of the futures contract would fall. Thus, he would be able to buy his "offsetting" position at a price below that at which he initially sold the contract; and the profits earned from trading in futures would offset the losses incurred in producing mortgages. As in the over-the-counter forward market,

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11/ There are presently four contract markets--two on the Chicago Board of Trade and one each on the Commodity Exchange and American Commodity Exchange. Three of these trade agreements call for delivery of GNMA securities of given yield on specified future dates. The fourth calls for delivery of a Collateralized Depository Receipt (CDR), an instrument which gives its holder a claim on GNMA securities held in safekeeping by the depository.

many participants in the futures markets assume positions in futures that are not covered by offsetting positions in mortgages. Such traders generally are attempting to profit from expected interest rate changes.

The futures market offers several advantages relative to the forward market, including the reduction in credit risk which results because the exchange stands behind every contract. But many participants continue to find the forward market more attractive. An important consideration is the ability to make purchases precisely tailored to the amount of securities one wishes to sell or to buy in the forward market, while trades in futures are for standardized blocks. Another is that while futures contracts are based on GNMA securities bearing a given coupon interest rate, delivery under these contracts can be made with any GNMA security, with the delivery price of securities with various coupons adjusted by a standard formula to provide investment yields equivalent to that on GNMAs with the base coupon rate. The problem with this arrangement is that GNMAs with different coupons do not trade in the cash market with the same yield to maturity. Instead, market forces generally set yields on high coupon GNMAs at levels that are higher than those set on lower coupon GNMAs. (High coupon issues are subject to more rapid repayment; also the return on low coupon issues that trade at prices below par is partly in the form of capital gains that are taxed at relatively low rates by the federal government.) The effect of this disparity in yields is to make the cost to a short of acquiring high coupon issues--to fulfill delivery obligations--less than the cost of low coupon issues. Thus, shorts generally deliver high coupon issues. Correspondingly, the longs who take delivery of high coupon issues

receive securities that have a lower market value than lower coupon issues. Still another feature is that the most actively traded contract specifies that delivery will ordinarily be in the form of a collateralized depository receipt (CDR)--which is backed by a pool of mortgages held in trust by the depository--rather than actual GNMA securities.

Finally, until recently margin requirements were not imposed on forward transactions and apparently are still not on the majority of trades, while the futures market requires posting of an initial margin and margin maintenance. While this latter provision offers the clear advantage of virtually assuring that the other party to the contract will fulfill his contractual obligations, it presents the disadvantage of tying up limited capital of mortgage bankers. Those operating with highly leveraged positions, the typical condition of the mortgage banker, find this particularly a problem. The placement of initial margin is not a great burden because this presently can be met by pledging liquid assets or by submitting an irrevocable letter of credit from a commercial bank. Futures markets, however, require participants to put up cash when the market moves against a position, and this can create a serious liquidity strain during periods of sharp changes in interest rates.

## FHLMC-Guaranteed Mortgage Pass-Through Securities

### Characteristics of Instruments

The mortgage pass-through securities programs operated by the Federal Home Loan Mortgage Corporation (generally referred to as Freddie Mac) were established after the GNMA program and are designed to further develop the secondary

markets for conventional mortgages--a component of the market not touched by the GNMA program. Cumulative issuance of FHLMC-guaranteed securities remains substantially below the volume of GNMA issues (roughly $18 billion vs. $100 billion for GNMA), although issue volume has increased substantially in recent years. These securities carry only the guarantee of the Federal Home Loan Mortgage Corporation rather than the full faith and credit guarantee of the federal government which is imparted with a GNMA guarantee.

Freddie Mac purchases residential mortgages from originators--primarily members of the FHLB System--financing them by sale of mortgage pass-through certificates. 12/ In its mortgage purchase programs, the corporation conducts weekly auctions of mandatory delivery commitments to purchase conventional home mortgages. Once a month, it also conducts an auction in which it sells "puts" or standby commitments to bidders which are similar to those offered by FNMA in its biweekly auction program. The mortgages acquired under these programs are pooled into groups, and FHLMC issues Guaranteed Mortgage Certificates (GMC) or Mortgage Participation Certificates (PCs) against these pools. The former is a "bond-like" instrument in that it pays interest twice annually, while payments of principal are passed through once a year. The latter is a pass-through instrument with cash-flow features similar to CNMAs.

## Investors

As with GNMA securities, the program has successfully attracted funds to the mortgage market from nontraditional lenders in this market. FHLMC esti-

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12/ FHLMC also raises some money by participating in the issuance of consolidated obligations of members of the Federal Home Loan Bank System.

mates that all but about 20 percent of its GMCs and PCs are held outside savings and loan associations by institutional investor groups ranging from commercial banks and their trust departments to public pension funds. Individuals and credit unions also own a small portion of the total.

Origination and Trading

In recent years, FHLMC has placed issues of PCs with selected securities dealers (at present 14 major firms) which distribute them to investors. GMC issues are marketed through the FHLB System Office of Finance which sells them through the dealer group utilized for issues of FHLB System debt. Thus, this marketing arrangement gives FHLMC closer control over the initial distribution of its securities than GNMA has. GNMA is, of course, able to impose controls indirectly by setting down guidelines regarding the terms on which mortgage originators issue GNMAs and the types of dealers with whom they deal.

The Freddie Mac program also must adapt to the underlying reality of the mortgage production cycle. As noted above, its commitments to acquire mortgages generally are made well in advance of the date that mortgages are actually delivered. To minimize the corporation's exposure to interest rate risk, it sells its pass-through instruments on a forward basis, with the forward time often 3 to 4 months in the future but sometimes extending as long as one year.

Also, as with GNMAs, there is very active secondary market trading in Freddie Mac securities. Yet to be issued securities are effectively resold many times in the forward market. Already issued Freddie Mac issues also trade relatively actively. To date, transactions in Freddie Macs are not cleared

through the MBSCC, though it is reported that this is under active consideration.

## Other Government-Guaranteed Securities

In addition to mortgage-backed securities that are guaranteed by GNMA or by FHLMC, there are several large government guarantee program that are designed to increase the availability of credit to targeted borrowers. While the Federal Financing Bank purchases a large volume of guaranteed obligations each year, a growing volume is also being sold to private investors.

### Guaranteed Loans

Guaranteed obligations that are purchased by private investors are of two broad types--loans and bonds. Guaranteed loans traditionally have been partially guaranteed (usually 90 percent) and have been originated, serviced and held by commercial banks. In the mid-1970s, however, liberalization of guarantees encouraged the development of secondary markets for the guaranteed portions of the loans.

Currently the most active non-housing related loan guarantee programs are the Small Business Administration's business loan program, the Farmers Home Administration's business and industrial loan program, and the National Oceanic and Atmospheric Administration's fishing vessel program. Legal opinions have been obtained from the Comptroller General for each of these programs which permit the guarantees to be passed through to the secondary investor, regardless of fraud or mismanagement on the part of the servicer of the loan. The extension of unqualified guarantees to the secondary holders, together with the splitting

of the guaranteed and nonguaranteed portions in the case of the SBA and FmHA 90-10 programs, has permitted significant secondary marketing of the guaranteed portions.

FMHA, SBA and NOAA loans are not fungible and, under current law, the guarantee does not extend to the holder of a certificate that represents a participation in a pool of guaranteed loans. Each loan has discrete terms as to size, maturity, fixed or variable interest rate, and amortization schedule. The guaranteeing agency oversees the origination of each loan and the original sale of the guaranteed portion in the secondary market.

In large part, the guaranteed loan market is a private placement market in which the loan originator sells the guaranteed portion to a securities dealer and the dealer resells the loan to an investor. The largest customers are pension funds, life insurance companies, and retirement plans for high income professionals who hold rather than trade the obligations. The discrete loan terms are taken into consideration in pricing each piece, and the absence of homogeneity among the loans restricts trading. Several dealers have become active in placing guaranteed loans with investors, and they "make markets" in the loans in that, to provide their customers with liquidity, they stand ready to repurchase obligations from their customers and resell them.

The Economic Development Administration in the Department of Commerce and the Federal Aviation Administration have 90-10 programs under which loans are being financed. While neither of the programs provides a secondary guarantee now, each is working on the legal changes that would be required to provide the secondary guarantee. EDA had $0.9 billion of guaranteed loans outstanding at

the end of fiscal year 1979 and is projected to have $3.4 billion out at the end of fiscal year 1981. The FAA has expanded authority to guarantee aircraft loans, and its outstanding guarantees are projected to increase to $1.0 billion in fiscal year 1981 from $0.2 billion at the end of fiscal year 1979.

## Guaranteed Bonds

Maritime Administration (MarAd). MarAd Title XI ship financing bonds are usually sold to the public through underwriters, although smaller issues often are privately placed. (The current volume outstanding is about $5.7 billion.) Pension funds and life insurance companies are major purchasers, and hold rather than trade the obligations. While securities dealers make markets in the obligations to fill their customers' liquidity needs, there is no active secondary market.

HUD guarantees short-term subsidized low-income public housing and makes renewal project notes which are sold in the tax-exempt market. The notes are auctioned publicly in volumes of around $1 billion and are actively traded in the secondary market.

## The Market for Securities Issued by Government-Sponsored International Organizations

During the twelve months ending in September 1979, $8.5 billion were borrowed in the international capital markets by government-sponsored international organizations. Although 10 institutions issued international securities during the year, two organizations--the International Bank for Reconstruction and Development (commonly known as the World Bank) and the European Investment Bank--accounted for 75 percent of the volume of new debt. The primary purpose of most government-sponsored international organizations is to promote the

economic development of member countries by making loans to governments or to private enterprises.

The international bond issues of international organizations fall into two categories: Euro- and foreign bond issues. A Euro-bond issue is underwritten and sold in markets outside of the country whose currency is used to denominate the security. A foreign bond issue, on the other hand, is underwritten and sold in a single national market in the currency of the country in which the market is located. During the twelve months ending in September 1979, two-thirds of the international bond issues of international organizations consisted of foreign bonds.

The United States is an important market for the sale of these securities. Of the $1.9 billion of foreign bonds issued by international organizations during the third quarter of 1979, about 17 percent ($325 million) was marketed in the United States. None of these securities is directly guaranteed by the United States government, but some of the international organiations can call upon the United States if necessary to contribute a stated amount of capital for the institution's support.

During the 12 months ending in September 1979, the original maturities of the foreign bonds issued by international organizations ranged from 3 to 25 years; the original maturities of their Euro-bond issues ranged from 1 to 20 years.

Compared to the $48.3 billion of borrowing by domestic government sponsored agencies and mortgage pools during the 12 months ending in September 1979, the market for securities issued by government sponsored international organizations is relatively inactive.

# APPENDIX A

## U.S. TREASURY SECURITIES

### Growth and Composition of Federal Debt During the 1970s

Over the decade of the 1970s, the U.S. Treasury was faced with the task of financing massive budget deficits, particularly over the second half of the period, and an additional large volume of funds was needed by the Treasury in order to finance the lending activities of the Federal Financing Bank. As a result, as may be seen in table 1, the Treasury's net debt to the public increased $380 billion during the 1970s, raising the total amount of debt held outside agencies of the federal government by nearly 2-1/2 times.

Of the growth in publicly held debt over the 1970-1979 period, about $80 billion (21 percent) was issued in nonmarketable form. 1/ As can be seen in the table, the increase in nonmarketable debt was about evenly split among its three main components--savings bonds sold primarily to individuals, special issues to foreign official institutions, and "arbitrage" bonds issued to state and local governments. 2/ The growth of foreign special issues took place primarily in the three-year period 1971 to 1973, while growth of state and local arbitrage bonds was concentrated primarily in the years 1976 to 1978. The outstanding amount of the three types of nonmarketables, it might be noted, has declined since the end of 1979, with savings bonds dropping $5.6 billion during the first four months of this year.

As may also be seen in table 1, marketable debt held by the public grew $300 billion during the 1970s. About two-thirds of this increase was in the form of notes and bonds, which are issued with original maturity from one year to generally no more than 30 years, while the other one-third was in the form of Treasury bills, which have original maturity of one year or less. Most of the growth in Treasury bills occurred in the early 1970s, and this development together with the normal "aging" of outstanding debt resulted in a sharp decline in the average maturity of the marketable debt held by the public.

In early 1976, when the average maturity of the Treasury debt fell to a low of 2-years 5-months, the Treasury became concerned that a further erosion in the maturity of its outstanding debt might create serious problems in managing the debt. The Treasury therefore shifted toward issuance of longer-term securities, and over the four years 1976 to 1979, notes and bonds accounted for over

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1/ In addition to the nonmarketable securities issued to the public (and shown in the table), another $103 billion of nonmarketable Treasury debt was sold to the government investment accounts and trust funds during the 1970s.

2/ Many state and local borrowers chose to refund in advance outstanding issues that had been sold earlier at higher interest rates. In order to conform to certain tax regulations, these issuers reinvested the proceeds of their refundings in special nonmarketable Treasury securities ("arbitrage issues").

Table 1
U.S. TREASURY DEBT HELD BY THE PUBLIC
(Billions of dollars, end of calendar years)

| | 1969 | 1975 | 1979 |
|---|---|---|---|
| Total 1/ | 278.4 | 437.3 | 658.0 |
| Nonmarketable | 57.6 | 92.5 | 137.1 |
| Savings notes and bonds | 52.2 | 67.9 | 79.9 |
| Foreign | 3.7 | 21.6 | 28.8 |
| State and local | -- | 1.2 | 24.6 |
| Other | 1.7 | 1.8 | 3.8 |
| Marketable | 219.6 | 343.8 | 519.7 |
| Bills | 79.8 | 157.3 | 172.6 |
| Notes and bonds | 139.8 | 186.5 | 347.0 |
| Average maturity (in months) 2/ | 45 | 29 | 45 |

1/ Also includes small amounts of matured and noninterest-bearing debt.
2/ Average length of marketable interest-bearing public debt held by private investors.

90 percent of the increase in the total volume of publicly-held debt outstanding. Because of this change in the composition of debt issuance, the average maturity of publicly-held marketable debt rose to 3- years 9-months at the end of 1979, the same level that prevailed at the beginning of the decade.

## Ownership of Marketable Treasury Debt

The Federal Reserve is the largest holder of marketable Treasury debt, with 23 percent of the total at the end of 1979. (See table 2.) Foreigners--primarily foreign official institutions--increased their holdings of marketable Treasury debt dramatically during the 1970s, largely as the result of efforts to support a steadily weakening dollar. These two sectors together absorbed about one-half of the net increase of marketable Treasury debt during the decade. Among private domestic holders, commercial banks have traditionally been by far the largest, although their holdings have declined somewhat since the end of 1976, in both relative and absolute terms. Other major holders of the debt, in descending order of importance, include state and local governments, individuals, corporations, and insurance companies.

## Importance of the Treasury Market for its Participants

The size and depth of the market for Treasury securities facilitates execution of a myriad of private trading and investment decisions each day and permits the United States government to finance quickly and efficiently its activities even in times of financial or economic stress. The market for Treasury debt also plays a crucial role in the implementation of the Federal Reserve System's monetary policy. The Manager of the System's Open Market Account buys and sells U.S. government securities on a temporary or permanent basis to affect the volume of reserves in the banking system. Federal Reserve System payment for securities purchased add to bank reserves, while reserves are extinguished when firms pay for the securities sold by the System Account. The size and liquidity of the Treasury market permit these operations to be executed typically without advance notice, thus adding considerably to the flexibility of monetary policy actions undertaken to manage the money supply.

## The Process of Selling Marketable Treasury Issues

In the last few years the Treasury has, with but a few exceptions, sold its marketable debt through auctions. Three- and 6-month Treasury bills are auctioned each Monday and 52-week bills are auctioned every four weeks. Special "cash management" bills with maturities from a few days to several months are sold from time to time to bridge temporary low points in the Treasury's cash balance. The announcements of these auctions state the amount of bills to be sold and the deadline for the submission of bids. Competitive bidders must specify the amount and price of the bills for which they are

Table 2
OWNERSHIP OF MARKETABLE TREASURY DEBT
(Billions of dollars, end of calendar years)

| | 1969 | 1975 | 1979 |
|---|---|---|---|
| Total | 219.6 | 343.8 | 519.7 |
| Federal Reserve | 57.2 | 87.9 | 117.5 |
| Foreign | 6.7 | 44.9 | 95.0 |
| Private domestic | 150.5 | 211.0 | 307.2 |
| Commercial banks | 56.8 | 85.1 | 97.0 |
| Individuals | 29.0 | 24.0 | 34.2 |
| State and local | 27.2 | 33.0 | 43.6 |
| Corporations | 10.4 | 20.2 | 23.9 |
| Insurance companies 1/ | 7.6 | 9.5 | 14.4 |
| Other | 19.5 | 39.2 | 94.1 |

1/ Exclusive of banks and insurance companies.

NOTE: Figures are partially estimated, based primarily on the Estimated Ownership of Public Debt Securities by Private Investors (Source: *Treasury Bulletin*).

bidding. 3/ The Treasury also permits noncompetitive tenders without specification of price for amounts up to $500,000. These tenders are awarded in full by the Treasury. The Treasury then fills the competitive tenders beginning with those at the highest price until the entire amount of bills announced have been sold. Noncompetitive bidders pay the average auction price as determined by the competitive bidders, while each of the successful competitive bidders receives bills at the price specified on their tenders. The minimum denomination for all Treasury bills is $10,000.

The Treasury's sales of notes and bonds have also been placed on a fairly regular schedule. In 1973, the Treasury began to sell 2-year notes at specifically designated times once each quarter, and since 1975, 2-year notes have been offered regularly in the latter part of each month. With the success of the 2-year note cycle, the Treasury began issuing on a regular basis 4-year notes in the last month of each quarter (in 1975) and 5-year notes or 15-year bonds in the first month of each quarter (in early 1976). More recently, the Treasury has been issuing an intermediate-term note--about 5-1/2 years in maturity--early in the last month of each quarter.

In addition to the regularization of financing activity that has been accomplished by the establishment of the note cycles, the Treasury has standardized the mix of securities in its mid-quarter refundings. The Treasury usually offers a package of three securities in each of these operations--a note with maturity around 3 years, another note in the 7- to 10-year range, and a long-term bond.

Coupon auctions are similar to those for bills. Bidding is usually done on a yield basis--that is, bids are submitted in terms of a yield to maturity. Once the average yield for the auction is determined, the Treasury places a coupon on the issue that is slightly above the average yield, so the security is priced at a slight discount from par. Noncompetitive tenders for notes and bonds may be submitted in amounts up to $1 million. The minimum denomination for coupons is usually $1,000, except for notes with less than 4 years to maturity.

## Trading and Delivery Practices

A very large number of institutions participate actively in the market for Treasury securities. At the heart of this market, however, is a relatively small group of firms, located primarily in New York City, that are referred to as "primary" dealers. These dealers--presently about three dozen in number--generally bid for and are awarded a sizable portion of the securities offered by the Treasury in each auction. The dealers then redistribute the debt to investors.

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3/ The price is specified as a percentage of par. The increase in value from the original purchase price to par at maturity represents the investor's interest return.

The dealers also maintain an active secondary market for Treasury securities. They stand ready to buy and sell issues at stated prices (by making bid and offer quotes) to their customers and to other dealers. Such transactions are made for their own account with the objective of obtaining a profit by selling securities at prices higher than those paid for the securities. (Dealers do not charge commissions.) Dealers also profit if the interest earned on securities they own is greater than the interest they pay on the funds borrowed to finance those securities.

The dealers' trading activity recently has been about equally split between trades with other dealers and brokers and with customers (see table 3). The bulk of the interdealer trading is through brokers. These brokers deal only with the primary dealers. The brokers do not make markets or hold securities in inventory but merely reflect the bids and offers dealers give them. In return for putting buyers and sellers together, they are paid a commission. The great value to dealers of the brokers is that the latter provide rapid access to other dealers. Because the broker does not reveal the identity of the dealer on the other side of the trade, he provides anonymity for the dealers who do not wish to reveal their activity to another dealer. Some brokers display bid and offered quotes on closed circuit television screens placed in dealers' trading rooms. Dealers who wish to buy or sell at these prices call the broker to effect a transaction. Some brokers communicate bids and offers by telephone only.

Institutional investors make up the vast bulk of nondealer participants in the Treasury and agency securities market. Because the absence of credit risk and the unusual liquidity of such investments attract these investors, Treasury securities are sold at and trade at yields that are below those on all other taxable securities. Commercial banks are an important participant, although their share of dealers' trading volume has fallen from about one-third in the early part of the 1970s to about 15 percent.

The market for Treasury and agency securities is an over-the-counter market in which practically all trades are negotiated over the telephone by the buyer and seller. The parties must agree upon the particular security, the price, the amount, and the delivery date.

Trades in Treasury securities generally are delivered and settled on the same day or the next business day. However, when securities that have not been issued are traded (when-issued or WI trading), delivery takes place on the date of issuance (the date on which payment for the securities is made). The time interval between trading and delivery can be as much as two weeks. In the case of Treasury bills, WI trading generally begins once the Treasury has announced the date and size of an auction. For example, the Treasury usually announces the terms of its weekly 3- and 6-month bill auctions (held on Monday) on the Tuesday afternoon preceding the auction. Since payment is made on the Thursday following the auction, a WI trade in bills could call for delivery up to 6 or 7 business days in the future.

Table 3
TRADING ACTIVITY BY REPORTING DEALERS IN TREASURY SECURITIES
BY TYPE OF CUSTOMER
(Millions of dollars, daily average, par value)

| | 1977 | 1978 | 1979 |
|---|---|---|---|
| Total | 10,838 | 10,285 | 13,182 |
| U.S. government securities dealers | 1,267 | 1,135 | 1,448 |
| U.S. government securities brokers | 3,709 | 3,838 | 5,171 |
| Commercial banks | 2,295 | 1,804 | 1,905 |
| All other | 3,568 | 3,508 | 4,658 |

Source: Federal Reserve Bulletin.

The Treasury has placed restrictions on trading of coupon issues before auctions (participants are not allowed to submit a bid in a particular coupon auction if they have already made trades in that security) and therefore most WI trading in coupons takes place between the time of the auction and the payment date. In some cases, the time between auction and issuance date might be nearly two weeks.

Delivery and safekeeping of securities is, for the most part, handled by the computerized book entry system and the wire-transfer system provided by the Federal Reserve System.

## Dealer Financing and the RP Market

Dealers rely heavily on repurchase agreements (RPs) to finance their holdings of securities; that is, they sell a security with an agreement to repurchase the security on a specified date a few days or weeks hence. The dealer pays the investor an agreed-upon rate of interest on this "loan." It is increasingly the custom for the investor to obtain some margin by lending the dealer an amount of funds that is somewhat less than the market value of the securities involved. Nonbank dealers may also use collateral loans with banks to finance their inventories of securities, while dealer departments of banks may also use funds obtained from the parent bank to carry securities in position.

Dealers also arrange reverse RPs; that is, they buy securities from another party who agrees to repurchase the securities at a later date. The dealer receives an agreed-upon rate of interest on this loan. The dealer can do two things with the securities obtained in this fashion. One is to sell the securities short in the hope of buying them back at a lower price when it is time to terminate the reverse RP. In essence, this is a maneuver designed to profit from price declines and is one way in which dealers try to make their overall position conform to their outlook on interest rates.

The dealer firms can also place the securities out under an RP and try to pay less interest on the RP than they earn on the reverse RP. In this case, the dealer is acting as a financial intermediary, transferring funds from those who wish to lend money for short periods of time to those who wish to borrow. Dealers frequently call this their "matched book" operation. When they match the amounts and maturities of their RPs and reverse RPs exactly, they are not exposed to any interest rate risk, although they are exposed to credit risk in the event that one party (or both) cannot perform their part of the bargain. In 1979, exactly matched transactions of this sort by the dealers reporting to the Federal Reserve Bank of New York amounted to $13.8 billion on a daily average basis. When the maturities do not match exactly, the dealer is exposed to interest rate risk. For example, a one-week reverse RP balanced against 7 overnight RPs of the same dollar amount could turn out to be a losing proposition if overnight RP rates rise rapidly over the week.

In 1979 dealers arranged a daily average of $15.3 billion of RPs and $13.3 billion of reverse RPs (in addition to exactly matched transactions). Much of these, of course, were established to finance securities held in position or to finance short positions.

## Treasury Futures Market

Dealers have also been active in the interest rate futures market. These markets, which are located on organized commodity exchanges, have uniform contracts calling for delivery of a specific amount of a particular security on a designated date in the future at a specific price. The most active trading in futures occurs in contracts for 3-month Treasury bills, long-term Treasury bonds, and GNMA securities. The prices of these contracts are determined by the interplay of buying and selling activity on the floor of the exchanges where the contracts are traded.

In these commodity exchanges, at the end of each day the exchange clearing house interposes itself between buyer and seller, and becomes a seller to every buyer and a buyer to every seller. In turn the clearing house will collect margin from its members on each contract they entered into, and the members in turn obtain margin from their customers. At present, the minimum initial customer margin on the most active contracts generally ranges from $1,500 per $1 million contract in 3-month bills to $2,500 per $100,000 contract in bonds and GNMAs. Each day the clearing house marks to market its contract with clearing members to take account of gains or losses resulting from price changes that day. Thus, if a contract is held until delivery, all interim losses or gains will have already been reflected in the margin account. Only a small percentage of contracts is held until delivery, however, with most closed out earlier.

Dealers may at times use interest rate futures contracts to hedge against market risk--for example, selling bill futures contracts as a hedge against the Treasury bills they hold in position in anticipation of customer orders. Dealers also act as "arbitragers," by going long in a futures contract calling for delivery on one date and short in a contract for delivery on another date. The hope in these positionings is to profit from interest rate disparities.

Securities dealers constitute the single most active group in the interest rate futures markets. According to the most recent CFTC survey of positions in the three most active contracts, commercial traders held only about one-fifth to one-third of those positions. The remainder was held by futures exchange members and individuals, either singly or grouped together in commodity pools.

# APPENDIX B

## GOVERNMENT SPONSORED AGENCY SECURITIES

Government or federally sponsored agencies are organizations which were established by the federal government but are now privately owned. Their primary function is the channeling of credit and technical support to the housing and agricultural sectors. U.S. Treasury capital was repaid by the agencies when they became private and currently the Treasury neither provides financial support nor guarantees their securities. However, the sponsored agencies do still have emergency backstops at the Treasury; and the federal government maintains a measure of control over them by appointing some of their directors, setting debt limits, and approving the terms and timing of

With the exception of the Federal Home Loan Mortgage Corporation (FHLMC) and the Student Loan Marketing Association (SLMA) which were established in the early 1970s, the sponsored agencies have existed in one form or another for at least several decades. The Banks for Cooperatives (BC) and the Federal National Mortgage Association (FNMA) were all established during the 1930s, while the Federal Land Banks (FLB) and the Federal Intermediate Credit Banks (FICB) have an even longer history. The FLB, FICB, and BC, which are under the overall supervision of the Farm Credit Association and together are called the Federal Farm Credit Banks, serve the agricultural sector whereas FNMA, FHLB, and FHLMC assist housing.

Discussion in the following sections will review the financing activities of FNMA, FHLB, and the Federal Farm Credit Banking System. The activities of the FHLMC are discussed separately in Appendix D. SLMA will not be reviewed because the guaranteed student loans acquired by this agency are financed solely by debt issued to the Federal Financing Bank.

### Description of the Agencies

The twelve Federal Land Banks, the oldest of the sponsored agencies, were created in 1917 pursuant to the Federal Farm Loan Act of 1916. While most of the original stock was government owned, there has been no government capital in the banks since 1947. Since that date the banks have been completely owned by the Federal Land Bank Associations which in turn are owned by farmers and ranchers who belong to the associations. The FLB are authorized to make mortgage loans in rural areas with maturities of from 5 to 40 years. The loans are extended for such purposes as the purchase of homes, real estate, equipment and livestock, and the refinancing of existing debt.

The twelve Federal Intermediate Credit Banks, whose regions coincide with those of the FLB and the BC, were established under the Agriculture Credit Act of 1923. Their function is the provision of short- and intermediate-term credit to farmers, ranchers, and commercial fishermen primarily for their marketing needs. Federal government holdings in the FICB ended in 1968 and the banks are now entirely owned by some 430 local production credit associations.

The association members are the borrowers who must use a specified percentage of their loans to purchase stock in the lending association. The FICB do not themselves make loans to individuals but, rather, lend to and discount paper for the production credit associations and financial institutions which do provide financing to farmers, ranchers, rural homeowners, owners of farm-related businesses, and commercial fishermen.

The third group of sponsored agencies serving the agricultural community, the Banks for Cooperatives, is composed of a central bank and 12 regional banks. Like the Farm Credit Administration which supervises all three groups, the BC came into being pursuant to the Farm Credit Act of 1933. Entirely owned by borrowing cooperatives since the end of 1968, the BC lend funds to agricultural and fishing cooperatives which provide various kinds of services such as marketing and processing to their members. The principal function of the central bank is to participate in large loans originated by the regional banks which exceed the legal lending capacity limits of the individual banks.

Prior to 1975, each of the three sets of Federal Farm Credit Banks financed their activities by issuing their own respective consolidated bond obligations. Owing to the maturity of their assets, the Federal Intermediate Credit Banks and the Banks for Cooperatives sold primarily bond obligations maturing in less than one year, while the Federal Land Banks sold bonds with a maturity mainly in the 1- to 6-year range. Starting in 1975, the Federal Farm Credit Banks began to sell discount notes that were the consolidated obligations of all 37 banks in the system. The discount notes are issued with maturities up to 270 days. After some experimenting with offerings of systemwide bond obligations, the Federal Farm Credit Banks began in January 1979 to raise money exclusively by issuing systemwide obligations. Currently, all debt obligations issued by the Federal Farm Credit Banks are the joint obligations of the 37 banks.

As of the end of 1979, the total amount of outstanding marketable debt of all the Federal Farm Credit Banks was $52.5 billion. Of this total, $3.2 billion was in the form of discount notes with an average maturity of about 32 days. The remaining $49.3 billion of outstanding bonds had an average maturity of 2-years 4-months. The breakdown of outstanding obligations for the three sets of banks was $28.3 billion for the Federal Land Banks, $16.5 billion for the Federal Intermediate Credit Banks, and $7.7 billion for the Banks for Cooperatives. Slightly more than 40 percent of bonds now outstanding are in the form of systemwide obligations.

<u>The twelve Federal Home Loan Banks</u>, the oldest of the sponsored housing agencies, were established in 1932, a time when many home financing institutions were in difficulty. The primary function of the banks is to provide loans for member savings institutions engaged in residential mortgage financing. While the banks have been privately owned by these savings institutions since 1951, they remain subject to the policies and supervision of the

Federal Home Loan Bank Board, an independent agency in the executive branch of the federal government. To provide credit to their members, the FHLB jointly issue medium- and long-term consolidated obligations of various maturities. At the end of December 1979, $27.7 billion of FHLB medium- and long-term debt was outstanding. To meet short-term needs the banks also sell discount notes, and at the end of the fourth quarter 1979, $5.4 billion of these notes were outstanding.

The Federal National Mortgage Association was originated in 1939, was rechartered in 1954, and then was divided into two separate corporations in 1968. These two entities are the now privately owned FNMA which conducts secondary mortgage market operations 1/ and the Government National Mortgage Association (GNMA) which remained in the Department of Housing and Urban Development and assumed special assistance functions which aid certain kinds of housing. (See Appendix C for a discussion of GNMA.)

FNMA was initially established to provide a secondary market for FHA-insured mortgages and 10 years later, in 1948, was also authorized to purchase and sell VA-guaranteed mortgages. FNMA's activities were restricted to these segments of the market until the Emergency Home Finance Act of 1970 empowered it to deal in conventional mortgages as well. FNMA is by far the largest of the housing sponsored agency borrowers with outstanding debt of almost $50 billion at the end of 1979. (This excludes about $700 million directly placed with state and local governments.) The bulk of FNMA's outstanding debt is in the form of medium- and long-term debentures though it also has liabilities of about $7 billion in short-term discount notes. In addition, FNMA has issued a small amount of GNMA-guaranteed mortgage-backed bonds, though no such securities have been offered recently.

## Characteristics and Structure of Agency Debt

Securities issued by federally sponsored agencies are, with a few minor exceptions, not guaranteed by the United States. 2/ Regardless of the absence of direct government guarantees, agency securities are considered to be almost as credit worthy as the securities of the U.S. Treasury. The high regard with which the market views the credit of the agencies exists largely because the agencies were created by the Congress and the market believes that the integrity of the agencies is linked to that of the federal government.

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1/ In its secondary market operations FNMA conducts a bi-weekly auction of commitments to purchase mortgages on 1- to 4-family houses. It employs more individually tailored techniques for its larger project mortgage purchases.

2/ The exceptions are several FHLMC and FNMA issues which are guaranteed by GNMA.

For this reason agency securities are considered to be close substitutes for Treasury securities in investors' portfolios.

Agency securities bear semi-annual coupons with the exception of short-term discount notes. Minimum denominations vary but some issues are available in $1,000 denominations and almost all can be purchased in $10,000 denominations. Most new offerings are available only in the form of a book-entry on the records of the Federal Reserve Banks but many outstanding issues are in bearer form.

Agency securities ordinarily yield a bit more than Treasury securities of comparable maturity because they are not direct obligations of the United States and because the market for these securities is not as broad as the market for Treasury securities. The difference or spread between yields on agencies and Treasuries of similar maturity varies in large part in response to the relative supply in each market. When the agencies are borrowing heavily while the Treasury is less active, the yield spread can be expected to widen. Another important determinant in the spread is the prevailing degree of tightness in the credit markets. In periods of tightness investors value more highly the liquidity of Treasury securities and consequently yield spreads against agencies tend to widen. Spreads averaged below 30 basis points in 1979, but in March 1980, a time of extremely tight market conditions, they climbed to as high as 100 basis points. In the early 1970s, when the long-term agency market was less developed, spreads between longer-term maturities were often well in excess of 100 basis points. Agency securities of short-term maturity sometimes yield less than Treasury securities. This usually occurs when the available supply in the agency market is thin.

With regard to the timing and maturities of new bond offerings, the farm credit agencies marketed 16 consolidated systemwide bond issues in 1979--monthly offerings of 6- and 9-month bonds and quarterly issues of medium-term bonds. Both the FHLB and FNMA restricted their borrowings to the medium-term area of 1- to 10-year maturities during the last two calendar years. The bulk of these offerings was in the 2- to 7-year range. FNMA made seven trips to the market in 1978 and eight in 1979 while the FHLB sold five new issues in 1978 and six in 1979.

Federally sponsored agency securities are lawful investments. As such, they may be accepted as security for all fiduciary, trust and public funds, including Treasury tax and loan accounts, the investment or deposit of which is under the authority of any officer of the United States. Agency securities are eligible for Federal Reserve Bank open market purchases and as collateral for Federal Reserve Bank advances to member banks. Also, they are eligible for purchase by national banks without restriction and for investment by federally chartered savings and loan associations and federally-chartered credit unions.

OWNERSHIP OF AGENCY MARKET SECURITIES BY HOLDER
AS OF DECEMBER 1979

| | Billions of dollars | Percent of total |
|---|---|---|
| U.S. government accounts and Federal Reserve Banks | 8.9 | 6.9 |
| Commercial banks | 23.6 | 18.3 |
| Mutual savings banks | 3.2 | 2.5 |
| Savings and loan associations | 6.1 | 4.7 |
| Life insurance companies | 1.1 | 0.9 |
| Fire, casualty and marine insurance companies | 1.4 | 1.1 |
| Nonfinancial corporations | 1.2 | 1.0 |
| State and local governments | 0.1 | 7.0 |
| General funds | (6.8) | (5.3) |
| Pension and retirement funds | (2.3) | (1.8) |
| All other investors | 74.0 | 57.6 |
| TOTAL | 128.6 | 100.0 |

Because of the low credit risk associated with agency securities they enjoy wide legal acceptability for institutional investors and their ownership is diverse. The following table shows the major holders of sponsored agency securities based on the Treasury Survey of Ownership at the end of 1979. According to the survey, the major holders were commercial banks with 18-1/2 percent, state and local governments with 6-1/2 percent, U.S. government accounts and the Federal Reserve Banks which also held 6 percent, and "all other investors" with 58 percent. In the period since year-end 1977, the major changes have been a rise in the "all other investors" share from 51 percent to 58 percent coupled with a 4 percentage point drop in the share owned by U.S. government accounts and the Federal Reserve Banks and a one percentage point decline in commercial banks' share.

While the Congress authorized the Federal Reserve System to deal in both federal and sponsored agency securities in 1966, the System confined its transactions to repurchase agreements (RPs) rather than to outright operations in agency securities until 1971. Until that time the agency market was not considered to have developed to a point where the System could conduct outright operations of a meaningful size without dominating the market. By 1971 the System reached the judgment that the agency market had developed to the point where outright transactions could be made without causing market distortions. The first purchases were effected in September of that year. The Federal Open Market Committee (FOMC) established certain criteria for open market operations in these securities. These guidelines were designed to limit the System's impact on the agency market by setting ceilings on the share of any one issue that the System could hold and establishing a minimum size for issues that the System could purchase. Over the next few years the System expanded the use of agency securities in open market operations, though in recent years the growth of its holdings has slowed. Starting in February 1977, System transactions were restricted to those agencies that cannot borrow from the Federal Financing Bank. Thus, open market operations in agency debt are now limited to sponsored agency securities.

## Marketing Techniques and Trading Characteristics

The main technique utilized by the sponsored agencies in marketing their new debt entails the use of a fiscal agent who offers the securities through a large nationwide selling group of dealers and commercial banks. Under the selling group technique, the agency employs a fiscal agent who maintains close contact with the financial community. (In the case of FHLB issues the Office of Finance of the FHLB Board serves this fiscal agency function.) Based on market conditions and subject to approval by the agency, the fiscal agent determines the size, price, maturity, and offering date of a new issue and engages a group of securities dealers to sell the issue to investors. (Either by law or by custom the agencies also clear new issues with the Treasury.)

Selling groups for most new securities are large, usually numbering in the hundreds, and their members are chosen for their ability to distribute securities. The fiscal agent will usually advise members of the selling group as well as the general public of the terms of a pending sale a few days before the offering date. The market is generally aware of a pending sale some time before, however, because most agency financing is on a regular schedule and agency cash needs can be estimated to some degree by the public. When the terms are known the selling group will canvass the market to uncover investor interest. The assessment of market demand gained through the selling group enables the fiscal agent to determine an offering yield which will satisfy both investors and the agency's need for an economical source of funds. The fiscal agent's determination of an offering yield (issues are usually sold at par) is announced the day before the offering date. On the offering date the fiscal agent apportions a share of the issue to each selling group member taking account of each member's past performance as well as the current magnitude of their customers' interest. Each member receives a commission for distributing the securities. Payment for the securities is usually due a week or two after the offering date. Securities are therefore sold on a "when-issued" basis in a primary offering. Selling groups for short-term discount notes are smaller in size and usually include major money center dealers who continually make a market in an agency's discount notes.

The secondary market for agency securities is mainly created by the same group of dealers who are most active in the market for U.S. Treasury securities. Transactions in agency securities are usually settled the next day. Forward transactions in agency securities are not common, although when-issued trading for a period of one or two weeks is necessary for the distribution of new issues. Futures markets for agency securities do not presently exist. The following table presents data on agency debt outstanding in the markets at the end of 1979.

The volume of trading activity in agency securities has grown considerably over the years, indicating a broadening market in which investors can conduct transactions easily and efficiently. Over the 15-year period from 1962 to 1977 the volume of trading activity increased from less than \$100 million to about \$1 billion. Average daily volume has continued to expand since that time, climbing well above \$2.5 billion in 1979. During the recent interval from 1977 through 1979 the most notable increase in transactions has been in agency securities with maturities of one year or less.

This active market has resulted in narrow spreads between a dealer's buying and selling prices; major dealers ordinarily quote their offering rate from 2/32 to 8/32 above their bid price. While a dealer may quote wider spreads for a smaller, long-outstanding issue for which the market has become less active, even such issues are readily marketable and a market price can be determined. Quotations for outstanding agency securities are published daily by many dealers, and the financial press, as well as many other newspapers, print agency quotations daily.

Table 2

FEDERALLY SPONSORED CREDIT AGENCY DEBT OUTSTANDING
(As of Dec. 31, 1979 - millions of dollars)

| Agency | Notes | Bonds | Total |
|---|---|---|---|
| Federal Home Loan Bank Board | 5,619 | 27,711 | 33,330 |
| Federal National Mortgage Assoc. | 6,392 | 39,900 | 46,292 |
| Federal Farm Credit Banks: | 3,259 | 49,223 | 52,482 |
| Consolidated Obligations | 3,259 | 29,957 | 33,216 |
| Federal Land Banks | 0 | 16,006 | 16,006 |
| Federal Intermediate Credit Banks | 0 | 2,676 | 2,676 |
| Banks for Cooperatives | 0 | 584 | 584 |
| TOTAL | 15,270 | 116,834 | 132,104 |

# APPENDIX C

## GNMA GUARANTEED MORTGAGE-BACKED SECURITIES

The Government National Mortgage Association (GNMA) was established in 1968 through amendment to the National Housing Act. Set up as a government corporation within the U.S. Department of Housing and Urban Development, GNMA administers two major types of mortgage support programs. Through its Special Assistance Function (SAF), which was inherited from the Federal National Mortgage Association (FNMA) when that agency was converted to a privately owned corporation in 1968, GNMA carries out a number of interest rate subsidy programs designed to provide support for specific types of housing. Secondly, GNMA administers the Mortgage-Backed Securities (MBS) Program, which was designed to increase liquidity in the secondary mortgage market and attract new private sources of funds into residential loans. Under the MBS program, GNMA guarantees the timely payment of principal and interest on passthrough securities that are issued by private financial institutions and are based on pools of government-underwritten residential mortgages that are originated by private lenders.

### Formation of the Mortgage Pools

The mortgage pools backing issues of GNMA-guaranteed securities consist primarily of FHA-insured and VA-guaranteed home loans and Farmers Home Administration home loans. Other types of government-underwritten mortgages also have been pooled in limited amounts: FHA-insured multifamily construction loans, FHA-insured long-term multifamily mortgages, and FHA-insured and VA-guaranteed mobile home loans (table 1).

The minimum pool size is $1 million for home mortgages and $500 thousand for multifamily and mobile home loans. Mortgages making up a pool must be uniform with respect to type of dwelling and coupon interest rate, and the loans must be less than one year old. 1/ The home mortgages have a maximum maturity of 30 years, whereas the multifamily mortgages may run as long as 40 years.

The pools of government-underwritten loans backing issues of GNMAs ordinarily are formed by private mortgage originators without the involvement of GNMA's own funds. In some cases, however, the mortgage pools have been made up of FHA/VA loans sold by GNMA--loans that GNMA previously had acquired under its Special Assistance Function programs in connection with the single-family "tandem plans." In these cases, the mortgages were sold back to the originators who then assembled the mortgage pools, issued the GNMA-guaranteed securities, and placed them with the syndicates of security dealers that bid the highest prices in the MBS auctions conducted by GNMA. GNMA has not pur-

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1/ There are exceptions for the mobile home loan program.

Table 1
GNMA-GUARANTEED PASSTHROUGH SECURITIES BY TYPE OF POOL
(December 31, 1979)

| Type | Original balance ($ thousands) | Percent distribution | Number of pools |
|---|---|---|---|
| Single-family | $85,869,831 | 93.8 | 32,929 |
| Project loans | 1,810,032 | 2.0 | 437 |
| Construction loans | 825,415 | .9 | 97 |
| Mobile homes | 1,057,910 | 1.2 | 1,159 |
| Graduated payments | 1,857,518 | 2.0 | 862 |
| Serial notes | 129,283 | .1 | 26 |
| Sub-total | $91,549,989 | 100.0 | 35,510 |
| Terminated pools | 720,977 | | 385 |
| Total issues | $92,270,966 | | 35,895 |

Source: Government National Mortgage Association.

chased mortgages under the tandem plan since 1976. 2/ In the event that the single-family tandem plan is resurrected to help limit cyclical downswings in residential mortgage activity, this link between the SAF and MBS programs may reappear.

Before GNMA-guaranteed securities are issued, the mortgages assembled in the pools to back them are removed from the balance sheets of the originating institutions and are placed in trust with a GNMA-approved custodian (usually a commercial bank). The custodian examines the documents, certifies their authenticity, and holds them for safekeeping; these documents, and payments of mortgage principal and interest received by GNMA issuers but not yet passed through to investors, represent GNMA's collateral for the guarantee. 3/

## Characteristics of the GNMA-Guaranteed Certificates

A GNMA-guaranteed passthrough certificate is a claim on a share of the income from a specific pool of government-underwritten mortgages. The certificates are issued by private institutions that originate the mortgages and assemble the pools. The originator/issuer generally continues to service the mortgages in the pools, collecting principal and interest payments from mortgagors and passing payments through to the holders of the securities. GNMA guarantees that the issuers will maintain payments of principal and interest from the mortgages to holders of the securities on a timely basis. The GNMA guarantee of issuer performance is backed by the full faith and credit of the U.S. government. GNMA has unlimited authority to borrow from the Treasury to meet its obligations under the guarantee.

The GNMA-guaranteed certificates currently being issued are passthrough securities that are "fully modified" in the sense that scheduled monthly payments of principal and interest from mortgages in the pool are provided to the holder of the security, whether or not collected by the mortgage servicer, plus a pro rata share of any unscheduled recoveries of

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2/ GNMA purchased $6.9 billion of single-family FHA/VA mortgages under these tandem programs between November 1971 and September 1976, and resold $4.9 billion of the loans during 1975-76 to syndicates of security dealers through auctions of mortgage-backed securities. The remainder were sold by GNMA through whole-loan auctions, and they generally were declared by GNMA to be eligible for pooling.

3/ In addition to the mortgage documents, the custodian holds an unrecorded assignment in favor of GNMA.

principal. 4/ Sales of mortgaged property are the most important cause of prepayment prior to contract maturity, but refinancings and foreclosures also can be significant factors. Thus, the cash flow to investors may vary from month to month depending on the distribution of terminations for mortgages in the pool.

GNMAs that represent shares in pools of 30-year FHA/VA home loans generally are characterized by participants in the market as securities with expected lives of 12 years. 5/ The 12-year life assumption is based upon termination experience with FHA-insured loans accumulated over many years. This experience suggests that, on average, half of the mortgages in a pool will be terminated by the twelfth year.

The coupon rate on a GNMA single-family security is set 50 basis points below the contract rate on the mortgages in the pool, and this contract rate ordinarily is equal to the FHA/VA ceiling rate prevailing at the time the pool is formed. The servicer of the mortgages receives 44 basis points and GNMA receives a guarantee fee of 6 basis points. The 44-point servicing charge is 6-1/2 basis points higher than that typically earned by servicers of whole FHA/VA loans. This extra income compensates the GNMA servicer for administrative costs and for ensuring timely payment of principal and interest to the security holders, whether or not received from the mortgagors.

The minimum denomination for a newly issued GNMA-guaranteed passthrough security is $25,000; beyond this minimum, GNMAs are available in increments of $5,000. Securities representing shares in pools of mortgages that are partly paid off, of course, will have correspondingly smaller amounts of unpaid balances. Moreover, some securities dealers have organized GNMA mutual funds or unit investment trusts, with individual shares priced at $1,000.

GNMA-guaranteed certificates are issued only in registered form. However, the certificates are fully transferable and assignable; that is, they may be endorsed by the owners and assigned to other investors without reregistration. In these cases, of course, the cash flow from the mortgage pool continues to flow to the registered holder.

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4/ Some straight passthroughs were issued when the GNMA program first started, but almost all outstanding GNMAs are now fully modified.

5/ Yields on securities issued against pools of 40-year multifamily mortgages usually are quoted on the basis of prepayment in 20 years.

## Participants in the GNMA Market

Issuers. GNMA has specified a number of eligibility requirements for issuers of GNMA-guaranteed passthrough securities. Issuers must be FHA-approved mortgage lenders and approved by FNMA as mortgage servicers. GNMA also has established net worth requirements for issuers. Until October 1979, the minimum required net worth was $100,000 and the requirement could range only up to $250,000; within this range, the requirement depended on the type (single-family, multifamily, etc.) and the amount of securities issued. Under regulations implemented in October 1979, the net worth requirement is related to the type and amount of securities issued, with no set maximum. For example, an issuer of single-family GNMAs must have net worth of $100,000 plus one percent of the amount of securities outstanding in excess of $5 million but less than $20 million, plus 0.2 percent of any additional securities outstanding in excess of $20 million.

The major issuers of GNMA-guaranteed securities are mortgage companies, which originate the bulk of government-underwritten home loans (more than 80 percent in 1979). More than 900 institutions have issued GNMAs, and nearly two-thirds of the issuers have been mortgage companies--most others have been depositary institutions (table 2). Moreover, issue volume has been concentrated among a relatively small number of large institutions. The fifty largest issuers, (47 of which are mortgage companies) have accounted for nearly half of the total volume of GNMA issues.

Investors. In the early days of the GNMA securities program, the nonbank thrift institutions (S&Ls and mutual savings banks) were the major investors in GNMAs; in 1971, these institutions held nearly 70 percent of outstanding GNMAs. By the mid-1970s, the thrifts still held nearly half the volume of GNMAs outstanding, although diversified investors were entering the market in increasing numbers. Yields on GNMAs increased sharply relative to yields on Treasury and corporate securities in 1974 as the thrift institutions substantially reduced their purchase of GNMA securities in response to contracting deposit flows, and the large yield advantage helped overcome conceptual problems that had discouraged participation by some types of institutions. After the cyclical trough in 1975, the range of investors participating in the GNMA market broadened markedly.

As can be seen in table 3, by the end of 1979 holdings of the nonbank thrift institutions accounted for only about one-fourth of all outstanding GNMAs; the remainder was spread among every major category of investor. As the thrift institution share of the market declined in recent years, the shares of most other types of investors rose. A notable exception has been credit unions, where the share dwindled from nearly 7 percent in 1971 to about 2 percent in 1979. Investment by private individuals has remained between one and two percent of the total since the inception of the program.

Table 2
ISSUERS OF GNMA-GUARANTEED PASSTHROUGH SECURITIES BY TYPE OF INSTITUTION
(December 31, 1979)

| | Number of firms | Percent of total |
|---|---|---|
| Mortgage companies | 573 | 63.7 |
| Savings and loan associations | 170 | 18.9 |
| Commercial banks | 124 | 13.9 |
| Mutual savings banks | 22 | 2.4 |
| Credit unions | 1 | negl. |
| Other | 10 | 1.1 |
| Total | 900 | 100.0 |

Source: Government National Mortgage Association.

Table 3
PERCENT DISTRIBUTION OF HOLDINGS OF GNMA-GUARANTEED PASSTHROUGH SECURITIES BY TYPE OF INVESTOR
(1979 month ended)

| Investor groups | October | November | December |
|---|---|---|---|
| Mutual savings banks | 10.0 | 9.9 | 9.8 |
| Commercial banks | 6.0 | 6.0 | 5.9 |
| Savings and loan associations | 15.1 | 15.2 | 15.3 |
| Public retirement/pension funds | 9.9 | 9.7 | 9.6 |
| Private retirement/pension funds | .2 | .2 | .2 |
| Mortgage bankers | 3.1 | 2.9 | 2.6 |
| Securities brokers/dealers | 4.0 | 4.2 | 4.0 |
| Nominees | 26.7 | 27.5 | 28.8 |
| Corporations/partnerships | 10.3 | 9.9 | 9.3 |
| Private individuals | 1.6 | 1.5 | 1.6 |
| Credit unions | 2.2 | 2.2 | 2.1 |
| Life insurance companies | 3.1 | 3.1 | 3.0 |
| Other insurance companies | .3 | .3 | .3 |
| State & local govt. gen. funds | 5.9 | 5.9 | 5.9 |
| Fiduciary - individual | .2 | .2 | .2 |
| Fiduciary - institutional | .5 | .4 | .5 |
| Others | .1 | .1 | .1 |
| Terminated issues | .8 | .8 | .8 |
| Percentage | 100.0 | 100.0 | 100.0 |
| Total issued | $87,126,327 | $90,376,424 | $92,270,966 |

Source: Government National Mortgage Association.

While the participation of pension and retirement funds--major investor targets of the program--has increased, only about one-eighth of outstanding GNMAs are registered in the names of private (noninsured) and state and local government pension and retirement funds. Some portion of the large block of GNMAs registered in the name of nominees apparently represents investment by pension and trust funds, but the amounts involved are unknown. The figures for commercial banks include securities held in their trust departments--also an unknown quantity.

Institutions of all sizes have been attracted to GNMAs because of favorable yields and the high degrees of quality and liquidity. Federally guaranteed mortgage passthrough securities (primarily GNMAs) account for roughly three percent of the total assets of S&Ls in all size groups (table 4). At credit unions, some GNMAs are held by institutions in all but the smallest size groups (those with total assets under $100 thousand), but GNMAs account for more than three percent of total assets only in the largest size group (table 4). Only about 350 of the nearly 11,000 federally insured credit unions with total assets under $1 million held GNMAs at the end of 1978.

Brokers and dealers. Most firms making markets in GNMAs are members of the Mortgage-Backed Securities Association--now a division of the Public Securities Association. 6/ The association was established in 1972 to further development of the secondary market in GNMAs, and there currently are about 75 members of the group, including a number of major securities firms and commercial banks. A broker/dealer need not be a member of this group in order to trade GNMAs, and there are an estimated 20 nonmember firms currently active in the GNMA market.

Some transactions are arranged by firms serving merely as brokers between buyers and sellers. In most cases, however, the firms act as dealers in GNMAs, buying and selling securities on their own accounts. The major dealers are in the market continuously, making it possible for buyers and sellers to take or dispose of positions in GNMAs without significant delay. Over-the-counter trading conditions prevail in the dealer market; transactions take place on a negotiated basis and contract terms are not standardized.

## Distribution and Trading of GNMAs

New issues and the dealer market. An institution considering issuance of GNMAs against pools of FHA, VA, or FmHA mortgages it has acquired or

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6/ The group originally was called the GNMA Mortgage-Backed Securities Dealers Association. The name was changed twice--to the Mortgage-Backed Securities Dealers Association and then to the Mortgage-Backed Securities Association--and the group recently merged with PSA.

Table 4
GNMA-GUARANTEED PASSTHROUGH SECURITIES HELD BY SAVINGS AND LOANS
AND CREDIT UNIONS BY SIZE OF INSTITUTION
December 31, 1978
(Dollar amounts in thousands)

| | Insured savings and loan associations | | |
|---|---|---|---|
| Asset size group | Number of institutions | GNMA securities held | Percent of total assets |
| Less than $10 million | 381 | $62,203 | 2.7 |
| $10-25 million | 788 | 418,814 | 3.1 |
| $25-50 million | 904 | 912,928 | 2.7 |
| $50-100 million | 838 | 1,863,860 | 3.1 |
| $100-250 million | 729 | 3,691,061 | 3.2 |
| More than $250 million | 413 | 9,130,265 | 3.1 |
| Total | 4,053 | $16,079,127 | 3.1 |

| | Insured credit unions | | |
|---|---|---|---|
| Asset size group | Number of institutions | GNMA securities held | Percent of total assets |
| Less than $500 thousand | 8,124 | $2,168 | 0.1 |
| $500 thousand-$1 million | 2,704 | 5,136 | 0.3 |
| $1-2 million | 2,288 | 7,258 | 0.2 |
| $2-5 million | 2,039 | 51,971 | 2.7 |
| $5-10 million | 944 | 67,169 | 1.0 |
| $10-20 million | 540 | 129,180 | 1.7 |
| $20-50 million | 355 | 285,093 | 2.6 |
| More than $50 million | 127 | 766,096 | 5.9 |
| Total | 17,121 | $1,314,100 | 2.6 |

Sources: Federal Home Loan Bank Board, National Credit Union Administration.

plans to acquire must apply to GNMA for commitments to guarantee. GNMA commitments are available, in amounts up to the net worth limits discussed earlier to authorized issuers, regardless of market conditions, at a fixed fee that does not vary with the amount of the commitment. The GNMA commitments are good for at least one year (they may be extended an additional 60 days), and they provide for pooling of loans bearing any FHA/VA ceiling rate in effect during the commitment period.

Receipt of the GNMA commitment does not obligate the mortgage originator to issue GNMAs. Indeed, a mortgage originator that has obtained a GNMA commitment to guarantee and is accumulating an inventory of FHA/VA/FmHA mortgages may market the mortgages in a number of ways. He may commit to sell new issues of GNMAs to dealers in the forward cash market under a "mandatory" delivery contract. 7/ Alternatively, the originator may decide to wait until he has assembled a group of mortgages; then he may sell blocks of whole loans to investors (such as S&Ls or life insurance companies) or place them in pools and issue GNMAs for immediate delivery to private investors or to securities dealers. During the "assembly" period, the originator may cover the risk of price fluctuation on mortgage inventory by obtaining optional-delivery or "standby" purchase commitments from GNMA dealers or from FNMA, or through a hedge in the GNMA futures market. 8/ And in the cases where interest rates have risen relative to rates on mortgages accumulated in inventory, the originator may find it profitable to deliver mortgages to FNMA or to sell GNMAs to dealers under optional-delivery commitments obtained earlier. In recent years, mortgage companies have marketed most of the government-underwritten loans they originate either by issuing GNMA certificates or by selling whole loans to FNMA.

Forward prices for mandatory future delivery of new issues of GNMAs (those with coupons 50 basis points below the current or recent FHA/VA ceiling) are published by some dealers. The deferred-delivery prices generally are lower than the immediate-delivery prices for GNMAs when long-term interest rates are above short-term rates. Thus if a mortgage company utilizes forward commitments at the dealers, it forfeits some or all of the warehousing profits that are derived while assembling the pool of mortgages in a positive-carry

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7/ If delivery fails to be made under a mandatory delivery contract, the mortgage company is liable for any loss sustained by the buyer due to nondelivery.

8/ Four-month standby commitments may be obtained from FNMA through the biweekly Free Market System commitment auctions or through FNMA's 12-month convertible standby commitment program.

market. 9/ On those occasions when the term structure is inverted and there is a negative-carry, mortgage companies incur losses on mortgage warehousing and deferred-delivery prices available at dealers usually rise above immediate-delivery prices for GNMAs.

As the volume of trading in GNMAs has grown and the resale risk assumed by dealers has declined, spreads between bid and asked prices on new issues have fallen from more than 1 percentage point in the early days of the program to as little as 1/32 of a point--at least under normal market conditions. The price spread for new issues generally is the same for immediate delivery and for mandatory delivery in the forward market. Moreover, dealers ordinarily have not required mortgage companies to post margin to secure forward contracts.

Mandatory commitments for delayed delivery of new issues of GNMAs protect issuers against price declines during the period required to assemble the mortgage pools, but these contracts also prevent them from taking advantage of price increases. Optional-delivery or "standby" purchase commitments eliminate the disadvantage of mandatory commitments for mortgage bankers in periods of rising securities prices. 10/ To obtain this greater flexibility, the mortgage banker must pay a fee to the party agreeing to "stand by."

The GNMA dealers make markets in optional-delivery or standby contracts providing for delivery up to a year or more later. The optional-delivery standby commitment issued by the GNMA dealer is, in essence, a "put" option handled in an informal, over-the-counter options market. The fee paid by the mortgage banker to the dealer is negotiated. So is the "striking price," the price at which a GNMA with a specified coupon can be sold to the dealer upon the exercise of the standby commitment. A dealer issuing a standby may decide to reduce his risk exposure by obtaining a similar commitment from an investing institution to which he pays the bulk of the standby fee received from the mortgage company. In periods of rising interest rates, the cost of standbys at the dealers can increase considerably since the issuer of the standby (dealer or investor) is more likely to receive delivery of GNMAs priced below the market. At FNMA, on the other hand, fees for standby commitments are constant regardless of market conditions.

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9/ The cost-of-carry element--the difference between long- and short-term interest rates--usually dominates the pattern of forward-delivery prices, but interest rate expectations also can have an effect. Thus, the difference between immediate and forward delivery prices does not necessarily match the net gain or loss on mortgage warehousing.

10/ Standby commitment agreements generally specify that the seller must give 30 to 60 days notice of intent to deliver. At that point, the commitment becomes mandatory.

In the forward market (mandatory or optional), contracts between mortgage companies and securities dealers generally include an equivalent-yield clause that permits delivery of GNMAs issued against pools of mortgages bearing either the current FHA/VA ceiling rate or other ceiling rates that might be established during the life of the contract. Standard conversion factors, based upon the assumption of 30-year term and prepayment in 12 years for all coupons (in the case of securities issued against pools of home mortgages), establish delivery prices for various coupons that will produce yields "equivalent" to those agreed upon for the current coupon. 11/

Delayed-delivery contracts generally also specify that the securities delivered cannot be priced higher than par. This "par cap" reflects the reluctance of investors to absorb capital losses that accrue as premium securities approach maturity. It also protects dealers and investors against the possibility of outright losses that could occur on premium securities in the event of rapid prepayment of mortgages in the pools, and it limits the dollar outlay required of buyers that had committed to purchase a given amount of GNMAs (par value). 12/ On the other hand, the par cap can create complications for mortgage companies when the FHA/VA ceiling is increased; mortgages originated under the higher ceiling might have to be priced below market to meet a commitment to deliver GNMAs under an "equivalent" yield contract. Under such conditions, of course, the mortgage companies may buy the lower-coupon FHA/VA mortgages or GNMAs in the market to meet the commitments.

Investors often buy GNMAs for immediate delivery in the cash market. Some investors also buy GNMAs under mandatory-delivery arrangements in the forward cash market as a way of locking in asset yields at some margin over their anticipated costs of funds; such forward pricing of mortgage investments has been regarded as a legitimate form of hedging by the regulators of depository institutions, such as the FHLBB. Some also may issue standby commitments to buy in the future, receiving front-end fees in return. The demand for forward delivery commitments by GNMA issuers, however, need not be met by the supply of commitments issued by permanent investors. Speculators, who accept interest rate risk in the hope of making profits from changes in the market, provide a bridge between mortgage companies and mortgage investors. Moreover, securities dealers may take substantial positions on their own accounts.

The GNMA futures market. An organized futures market in GNMA-guaranteed securities has been in operation at the Chicago Board of Trade since late 1975, providing ways of hedging against interest rate changes for

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11/ As discussed below, actual market prices for various GNMA coupons may differ from the prices generated by this equivalent-yield formula.

12/ Rapid paydowns of premium securities can occur if market interest rates decline and the high-rate mortgages in the pools are refinanced by the borrowers.

GNMA issuers, investors and dealers. Actual delivery is generally not made on the futures market, because positions usually are offset before the futures contracts expire.

Mortgage bankers may sell GNMA futures contracts as a temporary substitute for a sale in the cash market. This "short hedge" tends to balance the risk of a long position in the cash market associated with the accumulation of mortgage inventory for later sale; losses incurred in the cash market when mortgage prices are falling should be approximately offset by gains realized on the futures contracts when the mortgage banker closes out its futures market position by buying back the contract at a profit (if mortgage prices are rising, the situation is reversed). On the other hand, companies committing to sell GNMAs in the forward market may simultaneously secure a "long hedge" in the futures market by buying an equivalent amount of futures contracts. Indeed, any institution committed to buy or sell GNMAs in the forward market may hedge this position by taking a position in the futures market equal to and opposite from its forward market position.

Hedging in the futures market involves some costs, such as brokerage commissions and opportunity costs associated with initial and maintenance margin requirements. 13/ Moreover, many mortgage companies hesitate to use the futures market because they prefer to hold open the possibility of capital gains on mortgage inventory while limiting the possibility of capital losses through use of optional-delivery standby commitments (from FNMA or from GNMA dealers). Some mortgage companies also had been deterred by complications surrounding the delivery instrument known as a collateral depositary receipt (CDR), formerly called a due bill, which was developed by the Chicago Board of Trade. 14/ In 1978, the American Commodities Exchange developed a GNMA futures contract allowing for settlement of short positions via delivery of actual GNMA certificates, and the Chicago Board of Trade subsequently added a similar contract. The CBOT's original GNMA contract market, however, remains by far the largest GNMA futures market.

Secondary market trading of GNMAs. About $48 billion of GNMAs were reregistered in 1979 (table 5). Moreover, dealers estimate that the actual volume of secondary market trading was substantially larger (perhaps by a factor of 10) due to trades involving assignment but not registration--primarily among the securities dealers. Until recently there was no central clearing house, and most transactions in GNMAs have been settled by individual dealers, either by delivery or by pair-offs and difference checks to settle trades.

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13/ The broker charges a "round turn" commission to sell and then buy a futures contract.

14/ Under this delivery system, the mortgage banker had to maintain a collateral pool of GNMAs to back his CDRs until they were surrendered.

Table 5
GNMA-GUARANTEED PASSTHROUGH SECURITIES TRANSFERRED IN SECONDARY MARKET
(Millions of dollars)

| Month | 1972 | 1973 | 1974 | 1975 | 1976 | 1977 | 1978 | 1979 |
|---|---|---|---|---|---|---|---|---|
| January | | 250 | 432 | 660 | 1,193 | 3,388 | 4,021 | 3,580 |
| February | | 283 | 495 | 805 | 1,475 | 3,177 | 3,491 | 2,820 |
| March | | 218 | 735 | 1,002 | 1,959 | 4,711 | 3,105 | 3,177 |
| April | 240 | 273 | 668 | 1,313 | 2,440 | 3,164 | 2,747 | 2,830 |
| May | 307 | 170 | 532 | 972 | 2,513 | 3,732 | 2,724 | 2,987 |
| June | 243 | 309 | 529 | 935 | 1,901 | 3,588 | 2,775 | 3,230 |
| July | 186 | 396 | 495 | 1,151 | 2,190 | 3,596 | 2,534 | 4,392 |
| August | 192 | 303 | 454 | 773 | 2,169 | 3,525 | 3,030 | 5,093 |
| September | 140 | 165 | 447 | 817 | 2,783 | 3,985 | 3,043 | 4,365 |
| October | 187 | 218 | 511 | 851 | 2,886 | 3,319 | 3,408 | 5,990 |
| November | 247 | 259 | 429 | 786 | 3,392 | 3,331 | 3,086 | 4,744 |
| December | 224 | 296 | 555 | 1,099 | 4,120 | 3,432 | 2,966 | 5,016 |
| Total | 1,966 | 3,140 | 6,282 | 11,164 | 29,021 | 42,948 | 36,930 | 48,224 |

Source: Government National Mortgage Association.

Yields on the higher-coupon securities traded in the secondary markets usually are higher than those on the lower-coupon securities (under the standard 12-year average life assumption). There apparently are two reasons for this difference. First, higher coupon issues have shorter expected maturities because there is a higher probability of early prepayment of the mortgages in the pools than there is for the mortgages in the low-coupon pools. Second, the price and yield pattern may also partly reflect tax considerations. The ratable share of discount income obtained by acquiring a newly issued GNMA at a discount from par must be reported to the Internal Revenue Service as ordinary income. But recoveries of price discounts on seasoned issues acquired in the secondary market--which arise because market interest rates decrease after issuance--are considered to be capital gains for tax purposes. Thus, for investors with marginal income tax rates above the tax rates for capital gains, deeply discounted issues will be relatively attractive, ceteris paribus. The favorable tax status of low-coupon GNMAs is an important factor in the determination of yield spreads among GNMAs with various coupons, in view of the important role of taxable institutions in this market.

Repurchase agreements. Securities dealers enter into repurchase and reverse-repurchase agreements in GNMAs. From the dealer's perspective, a repurchase agreement involves a sale of GNMAs for immediate delivery and a commitment to buy back an equivalent amount of the securities at a future date at the same price, plus a sum of money that yields a prearranged rate of interest over the period of the contract; for dealers, this is basically a financing transaction or borrowing. A reverse repo, on the other hand, involves the purchase of securities by a dealer and a commitment to sell back an equivalent amount of the securities at a specified price on a specified future date; an agreed-upon interest rate is earned by the dealer over the life of the contract, and for financial reporting the transaction is treated as a receivable collateralized by the security purchased.

Some major dealers advertise bid and asked interest rates for terms of 30, 60, and 90 days on repos, identifying an interest rate spread generally around 1/2 percentage point. However, as in other components of the market, practices are not standardized. Initial margins (in the form of price markdowns) may or may not be required, and the repurchase agreement may or may not be "marked" to the market in the event of price fluctuations. The securities may be re-registered, but it is customary to keep the securities in the name of the original owner during the period of time they are pledged as collateral under a repurchase agreement. However, in some cases the security "repurchased" may not be the same security that was sold. In the case of such "money" repos, collateral substitution is allowed and yield maintenance and par cap provisions are involved.

From an investor's perspective, a reverse repo with a dealer is a method of turning securities held in portfolio into cash for a short period at interest rates that may be favorable, relative to other short-term interest rates available in the market. An investor may do a repurchase agreement to

raise short-term funds without actually liquidating his assets. For some institutions, such as S&Ls, this can be an important mechanism for raising cash without taking losses when GNMA prices are depressed.

The MBS Clearing Corporation. In 1979, the MBS Clearing Corporation was established to offer services providing risk reduction and settlement cost savings to firms active in the GNMA forward market. Mortgage bankers, investors, and dealers may participate. The list of participants in early 1980 is shown in table 6.

On each day, MBSCC, utilizing the Midwest Clearing Corporation as facilities manager, produces two reports for each participant--a "Purchase and Sales Report" and an "Open Commitment Report." The P & S Report lists all pertinent information on each trade entered the previous day and serves as a formal comparison and confirmation of each trade. This Report eliminates the need for the exchange of commitment letters by both parties to a trade.

The Open Commitment Report is a detailed listing of all forward trade commitments that have been entered and have not yet been settled. The Report provides participants with a surveillance tool for open trades. It is from information contained in this Report that MBSCC calculates a daily mark-to-the-market for each participant. Each participant is required to post directly with MBSCC, or through an approved bank, a letter of credit, cash or qualified securities in an amount equal to 100 percent of any debit margin balance. This must be done within twenty-four hours after notice from MBSCC.

Settlement cost savings for participants result from MBSCC's ability to net trades each settlement month into a substantially fewer number of balance order deliveries than a firm would achieve by pairing off open trades with another firm. MBSCC routinely nets over 90 percent of all trades while firm-to-firm pair-offs normally net only 50 to 60 percent.

Table 6
PARTICIPANTS IN THE MBS CLEARING CORPORATION

| |
|---|
| ACLI Government Securities |
| Bach |
| Cantor Fitzgerald Agency |
| COMARK |
| Countrywide Funding |
| Dean Witter Reynolds |
| First Boston |
| Garban Ltd. |
| Goldman Sachs* |
| Hilliard Farber |
| JPC Brokers |
| Kidder Peabody |
| Loeb Rhoades |
| Merrill Lynch |
| MKI Government Securities |
| Neuberger Berman |
| Oppenheimer |
| Paine Webber |
| Salomon Brothers |
| S. E. First National Bank* |
| Thompson McKinnon |

* Applied for participation.

Source: MBS Clearing Corporation.

# APPENDIX D

## FHLMC MORTGAGE-BACKED SECURITIES

The Federal Home Loan Mortgage Corporation (FHLMC) was created as a corporate instrumentality of the United States under Title III of the Emergency Home Finance Act of 1970. The corporation is owned by the Federal Home Loan Banks and the Board of Directors consists of the three members of the Federal Home Loan Bank Board.

FHLMC was established primarily to develop secondary markets in conventional (nonfederally insured or guaranteed) residential mortgages. FHLMC has carried out its statutory responsibilities by purchasing residential mortgages primarily from members of the Federal Home Loan Bank System and by reselling mortgage assets out of its portfolio. In recent years, FHLMC has marketed its mortgages mainly through sales of mortgage passthrough securities that it both issues and guarantees.

The economic objectives of the FHLMC mortgage passthrough securities programs are generally the same as the goals of the GNMA program--increased liquidity in secondary mortgage markets and a broader investor base for residential mortgages. In the early days of the FHLMC programs, emphasis was placed on regional redistribution of mortgage funds within the S&L industry; FHLMC sought to purchase mortgages from S&Ls in capital deficit areas and to sell mortgage-backed securities to S&Ls in capital surplus areas. 1/ In recent years, FHLMC has added to this capital redistribution goal a second objective of attracting new sources of funds into the conventional residential mortgage markets.

Since its creation in 1970, FHLMC has utilized a variety of mortgage purchase and sale programs. Originally, FHLMC bought both government-underwritten and conventional residential mortgages (and participations in conventional mortgages) through an open-window system at advertised prices, and financed its activities out of its original $100 million in capital and by issuing debt. FHLMC has borrowed in debt markets primarily through the Federal Home Loan Bank System (short-term discount notes and consolidated FHLB obligations), and has issued a limited number of bonds guaranteed by GNMA.

FHLMC began to sell mortgages out of its portfolio in 1971 by issuing mortgage passthrough securities. FHLMC in 1975 designed a second type of passthrough securities to appeal to investors that prefer the cash-flow features of bonds rather than mortgages. 2/ In recent years, the cor-

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1/ As with GNMAs, the major type of FHLMC-guaranteed passthrough certificate may be classified as a mortgage asset by S&Ls and mutual savings banks for federal tax purposes.

2/ This type of security may not be classified as a mortgage asset by S&Ls and mutual savings banks for federal tax purposes.

poration has raised most of its funds--more than three-fourths in 1978 and 1979--through sales of mortgage passthroughs. In 1977, FHLMC abandoned the open-window system for purchasing conventional home mortgages and inaugurated an auction system designed to provide more competitive market prices to mortgage originators and to allow FHLMC to more closely control the volume of mortgage purchases. Also in 1977, FHLMC contracted with a group of securities dealers to participate in the retail of its major types of passthrough security, and to make secondary markets in the instrument.

## Characteristics of Mortgage Pools and Pass-Through Securities

The mortgage pools backing issues of FHLMC-guaranteed securities consist of conventional residential first mortgages (whole loans and participations) acquired by FHLMC primarily from members of the FHLB System through its various mortgage-purchase programs. 3/ The pooled mortgages are largely newly originated loans (less than one year old), although up to 20 percent of the cumulative aggregate principal balance of all conventional mortgages purchased by FHLMC can be seasoned loans. 4/ Each pool, when formed, generally has an aggregate unpaid principal balance ranging from $100 to $200 million and comprised of from 2,000 to 5,000 residential mortgages. At least 95 percent of the aggregate principal balance of the pool must consist of home mortgages (1- to 4-family), with the balance made up of multifamily mortgages. Not more than 2-1/2 percent of the home mortgages in a pool may be flexible-payment loans. At present, FHLMC purchases conventional residential mortgages with loan-to-value ratios exceeding 80 percent only if the principal amount in excess of 75 percent of the appraised value of the mortgage property is covered by private mortgage insurance.

FHLMC issues passthrough securities against the assembled pools of mortgages and the originators of the mortgages continue to service them. FHLMC issues two types of securities against the mortgage pools--Mortgage Participation Certificates (PCs) and Guaranteed Mortgage Certificates (GMCs). Both types represent undivided interests in pools of mortgages, but the cash flow patterns are different. As with GNMAs, the FHLMC PCs entitle holders of the securities to monthly payments of interest on the underlying mortgages;

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3/ Originally, FHLMC could buy mortgages only from federally insured depository institutions, and those insured depositary institutions that were not part of the FHLB System had to pay a nonmember fee when selling mortgages to FHLMC. In 1978 FHLMC was authorized to buy from mortgage companies, although these institutions also must pay a nonmember fee. In practice, most mortgage sales to FHLMC are from S&Ls.

4/ As of June 1979, seasoned loans (more than one year old) represented less than 5 percent of all conventional mortgages purchased by FHLMC.

scheduled payments of principal and mortgage prepayments are also passed through on a pro rata basis. 5/ The GMCs, first offered in 1975, pay interest semiannually, return minimum scheduled principal amounts once a year, and give holders the option of selling the certificates back to FHLMC in either 15, 20 or 25 years at par. They were designed for institutional investors that dislike the uncertain cash flow features of PCs and prefer semiannual rather than monthly remittances. GMCs account for about one-eighth of the dollar amount of all passthrough securities issued and guaranteed by FHLMC.

FHLMC PCs and GMCs are both issued in minimum denominations of $100,000 and have maximum maturities of 30 years. Yields on the PCs are quoted on the basis of 12-year average lives. 6/ The maximum average weighted life of a GMC has ranged between 8.3 and 10.8 years, considering the repurchase and minimum repayment provisions. The price at which FHLMC offers the securities depends on the coupon rates and current market conditions and in recent years the certificate rates have varied in increments of one-quarter of one percent. 7/ FHLMC PCs and GMCs are available only in fully registered form and are readily transferable.

The timely payments of interest and full payment of all principal on FHLMC PCs and GMCs are guaranteed by FHLMC; the securities are not guaranteed by the United States or by the Federal Home Loan Banks, and they do not constitute debt obligations of the U.S. or any FHLB. FHLMC's contingent liability is offset by a like amount of mortgage loans underlying the PCs and GMCs. In addition, FHLMC maintains a reserve for management fees and guarantees. Even though FHLMC passthrough securities are not guaranteed by the full faith and credit of the federal government, the yield on FHLMC PCs ordinarily exceeds that on GNMA passthroughs by only about 35 basis points. This typical yield relationship suggests that the investment community believes the FHLB System, or even the Treasury, might come to the aid of FHLMC if necessary to maintain payments on the securities.

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5/ Shares of prepayment fees on the mortgages also are passed through to the securities holders. Since FHA- and VA-underwritten mortgages do not have prepayment penalties, prepayment fees are not a factor in the GNMA-guaranteed securities market.

6/ The limited experience of FHLMC suggests that the average life of a PC actually will be less than 12 years, and internal FHLMC decisions are based on the assumption that the average life is between 6 and 8 years.

7/ FHLMC prefers to set the certificate rate on a passthrough security below the net yield on all mortgages in the pool. However, when market interest rates are rising sharply, this may not be possible. In these cases, FHLMC retains ownership of a portion of the mortgage pool and transmits interest received on this portion to the security holder to maintain payment at the certificate rate.

## Participants in the FHLMC Market

Issuer. FHLMC is both the issuer and the guarantor of its mortgage passthrough securities. Since FHLMC seeks to maintain only a modest mortgage portfolio, the volume of issues is determined primarily by the scope of its mortgage purchase programs. The volume of mortgage purchases depends partly on overall mortgage market conditions, but FHLMC can control purchase volume by varying the proportions of bids accepted in its auctions of mortgage purchase commitments. FHLMC has a limited capacity in terms of resources necessary to underwrite mortgages and administer the programs, and thus the Corporation sets limits on its level of operations.

Investors. During the first half of the 1970s, virtually all of the FHLMC passthrough securities were bought and held by members of the Federal Home Loan Bank System (primarily S&Ls). In recent years, however, participation by diversified institutions has expanded greatly. In 1979, institutions other than S&Ls purchased nearly 80 percent of the PCs issued by FHLMC (table 1). The GMCs have appealed to bond portfolio managers from the start, and the thrift institutions have bought only minor amounts of these securities.

Credit unions and individuals have purchased only minor amounts of FHLMC passthrough securities, perhaps because of the large minimum denominations. On the other hand, bank trust departments, insurance companies, and pension and retirement funds have been major investors in recent years.

Dealers. Prior to 1977, FHLMC marketed the PCs directly to investors, and the Corporation still maintains a small retail sales force. However, in January 1977 FHLMC contracted with a group of major securities dealers to participate in the retail distribution of the PCs; the FHLMC-approved group currently consists of 13 New York securities dealers and the Bank of America (table 2). The GMCs are marketed by the FHLBB Office of Finance through a special dealer group that they have formed.

FHLMC has established certain standards and procedures for its selling group of dealers. FHLMC evaluates all dealer applicants by reviewing audited financial statements to assure adequate net worth and by analyzing the operations and internal management of the dealers. Moreover, the sales control staff of FHLMC periodically conducts on-site compliance audits of each firm to verify reported sales activity and to ensure fair pricing. Certain activities are prohibited by FHLMC, such as purchasing optional-delivery PCs for the dealer's own account ("positioning") or reallowing any part of the dealer's sales concession to the purchaser ("customer-directed give-ups"). 8/

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8/ Sales concessions are discussed on page 8.

Table 1
PURCHASES OF NEW ISSUES OF FHLMC PCs
(Percentage distributions)

| Type of investor | 1978 | 1979 |
| --- | --- | --- |
| Savings and loans | 28.5 | 22.4 |
| Credit unions | 2.2 | 0.3 |
| Bank portfolios | 12.1 | 3.5 |
| Bank trust | 14.4 | 16.3 |
| Savings banks | 2.3 | 3.4 |
| Public pension funds | 13.6 | 9.4 |
| Private pension funds | 5.4 | 1.0 |
| Investment companies | 6.0 | 6.6 |
| Insurance companies | 8.4 | 16.9 |
| State and local government funds | 3.0 | 6.7 |
| Individuals | 0.2 | 0.1 |
| Dealer positions | 1.3 | 11.5 |
| Other | 2.6 | 2.0 |
| TOTAL | 100.0 | 100.1 |

Source: Federal Home Loan Mortgage Corporation.

Table 2
MEMBERS OF FHLMC PCs DEALER GROUP
(May 1980)

| | |
|---|---|
| Bache Halsey Stuart Shields, Inc. | New York, New York |
| Bank of America | San Francisco, California |
| A. G. Becker, Inc. | New York, New York |
| E. F. Hutton & Co., Inc. | New York, New York |
| Dillon Read & Co., Inc. | New York, New York |
| First Boston Corporation | New York, New York |
| First Pennco Securities, Inc. | New York, New York |
| Goldman, Sachs & Co. | New York, New York |
| Kidder Peabody & Co., Inc. | New York, New York |
| Lehman Government Securities, Inc. | New York, New York |
| Merrill Lynch Government Securities, Inc. | New York, New York |
| Paine Webber Jackson & Curtis, Inc. | New York, New York |
| Salomon Brothers | New York, New York |
| Shearson Loeb Rhoades, Inc. | New York, New York |

Source: Federal Home Loan Mortgage Corporation.

Distribution and Trading of FHLMC Securities

The GMCs are not sold on a regular basis (there were 4 issues in 1979), and issues are forthcoming only when FHLMC determines that market conditions favor issuance of this security. All transactions are on an immediate and mandatory delivery basis. There is no forward market for these securities and secondary market liquidity is quite limited.

Sales of PCs are conducted by FHLMC on a continuous basis and new issues are sold in a variety of ways to the securities dealers that participate in retail distribution. Sales are made under mandatory and optional delivery programs, and agreements may call for delivery on either an immediate or a delayed delivery basis. To reduce its risks, FHLMC generally attempts to tailor its PC sales volume to correspond to the volume it has generated or expects to generate under its major conventional mortgage purchase programs. FHLMC currently conducts weekly auctions of mortgage purchase commitments providing for mandatory delivery within 60 days, and once a month conducts an auction for optional forward commitment contracts.

Under mandatory delivery contracts, dealers commit to purchase from FHLMC a specified principal amount of PCs on a given date between 7 and 150 days from the trade date. Under optional delivery contracts, the dealer commits to buy up to a specified amount of PCs for delivery any time within a specified period; currently the commitment periods are 140 and 270 days. Neither a mandatory delivery contract nor an optional delivery contract may be assigned or transferred by a purchaser without the prior written consent of FHLMC.

FHLMC presently allows a sales concession to dealers involved in the retail distribution of PCs, in an amount no greater than 0.25 percent of the purchase price of the securities sold to the dealers; the dealers, in turn, are expected to place the issues with investors at the sales price. In the case of optional-delivery sales contracts, FHLMC pays the customer standby fees-not more than 1 percent for the 270-day program.

FHLMC does not require members of its PC dealer group to post initial or maintenance margins. The Corporation's retail sales force, however, retains the right to require a good faith deposit of up to 5 percent of the unpaid principal balance of the PC on the trade date. About half of the 14 dealers that distribute new issues of PCs reportedly are requiring maintenance margin (between trade and settlement dates) in forward contracts with some of their customers.

FHLMC maintains a secondary market for PCs, quoting bid prices for the repurchase of PCs and offering prices for currently issued PCs as well as PCs it has repurchased. Since 1977, securities dealers also have made secondary markets for PCs, and FHLMC has encouraged trading at the dealers; FHLMC's bid prices for repurchase may be below bid prices at

at securities dealers making a market in PCs, and FHLMC's offering prices for resales may be higher than the offering prices at the dealers. Members of the PC dealer selling group report that secondary market trading in PCs amounted to more than $20 billion during 1979. Spreads between bid and asked prices at dealers generally are 1/8 point for recently issued securities and ordinarily range between 1/4 and 1/2 point for more seasoned issues, although the size of spreads depends on overall market conditions.

FHLMC PCs are used as collateral in repurchase (or reverse repurchase) agreements between investors and dealers, or between two financial institutions. FHLMC has pointed out that these agreeements are solely between two private parties and the Corporation is not obligated in any way to either party.

# APPENDIX E

## GOVERNMENT GUARANTEED SECURITIES (OTHER THAN MORTGAGE-BACKED SECURITIES)

All federally guaranteed loans and bonds that currently are sold in the private capital markets are discussed below, except GNMA and FHLMC mortgage-backed securities. The latter are reviewed in detail in Appendices C and D.

Federal loan guarantees assure lenders that the government will pay all or part of principal and interest on a loan in the event of a default by the borrower. The use of loan guarantees was initiated on a large scale in the U.S. during the 1930's to assist purchases of homes. The loan guarantee concept was expanded in the 1950's and 1960's to assist marginal borrowers such as small businesses, students and low income families, who were unable to obtain credit or who could obtain credit only at high cost. In the 1970's loan guarantees became widely used to supplement budget outlays to achieve various other public policy objectives.

The Federal Housing Administration single-family mortgage insurance program was one of the earliest and remains the most successful of the guarantee programs. Prior to its establishment, most home mortgages had low loan-to-value ratios, matured in 5 or 6 years and provided for "balloon payments" of principal at maturity. This arrangement triggered a large number of foreclosures and bankruptcies during the Depression and caused private lenders to back away from the mortgage market. The FHA mortgage insurance program was initiated in 1934 to fill this important gap in credit availability. It assured private lenders that they could safely make long-term, low downpayment mortgage loans at reasonable interest rates.

The FHA mortgage insurance program is operated on an actuarily sound basis; FHA charges insurance premiums which are high enough to cover probable losses and operating expenses. The government pools the risk of a number of small loans, and borrowers as a group bear the risks through insurance premiums.

With the experience of a successful FHA insurance program, federal policymakers expanded the loan guarantee concept in the 1950's and 1960's to provide credit assistance for higher risk borrowers in order to achieve socially desired goals. Similar to loans guaranteed under the FHA mortgage insurance program, most of the guaranteed loans in this period were small and were financed by institutional investors, largely banks, insurance companies and pension funds. An example of the higher risk programs is the urban renewal program which was established in the Housing Act of 1954 to assist residents of urban renewal areas, whose record of creditworthiness had not been established, to obtain credit on properties whose future value was in doubt. Other higher risk programs include the Small Business Administration business loan guarantee program, which was established in 1953 to assist smaller, often thinly capitalized entrepreneurs. The Federal Ship Mortgage insurance program, which was established in 1938, was simplified and expanded in 1953 as part of larger efforts to assist the U.S. shipping industry. The Guaranteed Student Loan Program was established in 1965 to assist low- and moderate-income students in obtaining funds for post-secondary education.

Loan guarantees took on a new dimension in the late 1960's and the 1970's when federal guarantees were substituted on a large scale for direct federal loans and other program outlays in the federal budget. Such programs include the substitution of loan guarantees for below market interest rate direct loans to REA electric cooperatives, the use of loan guarantees for big projects such as those to promote energy self-sufficiency, and guarantees for special situations such as Chrysler and railroad restructuring. At the time the number of guarantees was expanding, the creativity of federal program managers and private market participants was being applied to establish secondary markets for guaranteed loans, such as FHA and VA-backed mortgages and SBAs, which traditionally had been held largely by the loan originator.

A large number of relatively small direct and federally guaranteed debt issues that resulted from the proliferation of guarantee programs caused market congestion and serious Federal debt management problems in the early 1970's. The Federal Financing Bank was established under legislation enacted in 1973 (P.L. 92-224, 12 U.S.C. 2281 et seq.) to centralize and better coordinate the timing and terms of sales of obligations that were issued, sold or guaranteed by federal agencies and to reduce the costs of federal and federally-assisted borrowing from the public. Under current FFB policy, the FFB borrows solely from the Treasury and uses the proceeds to purchase direct obligations of federal agencies and obligations that are fully guaranteed as to principal and interest by a federal agency. The FFB is a corporate instrumentality of the U.S. and is under the supervision of the Treasury Department.

To date, FFB policy has been to purchase obligations on original issue, rather than entering the market to purchase outstanding obligations. Thus, there remain outstanding balances of loans that were guaranteed to private holders prior to the time the program came into the FFB. An example is loans guaranteed by the Department of Defense under the foreign military sales program. Outstanding loans that are in private hands are in repayment status, and private holdings are declining.

As a broad indication of the size of the universe of federally-guaranteed obligations outstanding in the market, table 1 presents data on federally-guaranteed obligations that were held by private investors on September 30, 1979. This table includes private holdings of obligations that were issued under programs, such as Department of Defense foreign military sales guarantees, that currently are financed solely by the FFB. The table does not include guarantees of loans, such as those guaranteed by NASA under its space shuttle development program, for which there was no private market financing on September 30, 1979.

A narrower view of the size of the government-guaranteed market is presented in table 2, which excludes obligations issued under programs that currently are financed through the FFB. Table 2 presents summary information on obligations that are guaranteed and financed currently in the capital markets. It also provides a judgmental estimate of trading activity that is

Table 1
OWNERSHIP OF FEDERALLY GUARANTTED LOANS AND BONDS 1/
September 30, 1979

| Agency and program | Total | Holdings of federal entities | | | Privately held |
|---|---|---|---|---|---|
| | | FFB | Other federal 2/ | Spons. agency 3/ | |
| **Funds appropriated to the President** | | | | | |
| Foreign military sales | 5,670 | 5,271 | -- | -- | 399 4/ |
| Agency for International Dev. worldwide housing guarantees | 760 | -- | -- | -- | 760 |
| Overseas Private Investment Corp. | 92 | 36 | -- | -- | 56 |
| Callable capital of international dev. banks | 11,545 | -- | -- | -- | 11,545 |
| **Agriculture Department** | | | | | |
| Farmers Home Administration | 37,078 | 31,080 | 196 | -- | 5,802 |
| Commodity Credit Export guarantees | 136 | -- | -- | -- | 136 |
| Rural Electrification | 7,535 | 7,150 | -- | 385 | -- |
| **Commerce Department** | | | | | |
| Economic Development Admin. | 883 | -- | -- | -- | 883 |
| National Oceanic & Atmospheric Administration | 106 | -- | -- | -- | 106 |
| Maritime Administration | 5,703 | -- | -- | -- | 5,703 |
| **Education** | | | | | |
| Guaranteed student loans | 8,302 | -- | -- | 1,239 | 7,063 |
| Other education | 1,305 | -- | -- | -- | -- |
| **Energy** | | | | | |
| Geothermal resources | 14 | -- | -- | -- | 14 |
| **Health and Human Services** | | | | | |
| Health programs | 167 | 77 | -- | -- | 90 4/ |
| Medical facilities | 1,321 | 160 | -- | -- | 1,161 4/ |
| **Housing and Urban Development** | | | | | |
| Low-income project notes and bonds | 15,050 | -- | -- | -- | 15,050 |
| Urban renewal notes and bonds | 466 | 5 | -- | -- | 461 |
| New communities debentures | 141 | 38 | -- | -- | 103 4/ |
| **Mortgage Insurance** | | | | | |
| Federal Housing Admin. | 110,051 | -- | -- | -- | -- |
| Veterans Administration | 89,158 | -- | -- | -- | -- |
| Subtotal | 199,209 | -- | -- | -- | -- |
| Less GNMA pools of FHA/VA | 70,558 | | | | |
| FHA/VA outside of GNMA pools | 128,651 | -- | 3,105 5/ | 35,251 6/ | 90,295 |

Continued on next page.

Table 1 (continued)

| Agency and program | Total | Holdings of federal entities: FFB | Other federal 2/ | Spons. agency 3/ | Privatel held |
|---|---|---|---|---|---|
| Interior Department | | | | | |
| Indians program | 49 | -- | -- | -- | 49 |
| Transporation | | | | | |
| Rail program 7/ | 565 | 565 | -- | -- | -- |
| Washington Metro Authority | 997 | 177 | 117 | -- | 703 |
| FAA aircraft loan guarantees | 190 | -- | -- | -- | 190 |
| Treasury | | | | | |
| New York City 8/ | 500 | -- | -- | -- | 500 |
| Independent Agencies | | | | | |
| Export-Import Bank | 6,586 | -- | -- | -- | 6,586 |
| General Services Administration | 1,242 | 360 | 14 | -- | 868 |
| Small Business Administration | | | | | |
| Business loans | 7,621 | 431 | -- | -- | 7,190 |
| Lease and surety bond | 596 | -- | -- | -- | 596 |
| Lease guarantees | 228 | -- | -- | -- | 228 |
| Disaster loans | 7 | -- | -- | -- | 7 |
| Pollution control bonds (tax-exempt) | 55 | -- | -- | -- | 55 |
| TOTAL PRIVATE HOLDINGS OF GUARANTEED LOANS AND BONDS 9/ | | | | | 156,599 |

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Source: Special Analysis F of the Budget for Fiscal Year 1981.

1/ Listing includes only guarantee programs under which obligations have been issued to the public. None of the programs which has been financed solely through the FFB is listed. However, the listing does include the programs, such as foreign military sales, that wer financed in the market prior to establishment of the FFB.
2/ Includes the Federal Reserve and other government accounts.
3/ Includes Farm Credit, FNMA, FHLBs, FHLMC, and SLMA.
4/ All new guarantees financed through FFB; outstanding amounts were financed in market prior to program financing through FFB.
5/ GNMA holdings of FHA and VA mortgages.
6/ Includes \$33,971 million by FNMA, \$91 million by FHLBs, and \$1,180 million by FHLMC.
7/ Adjusted to remove DOT guarantee of USRA debt.
8/ Guarantee limited to certain New York City and state pension funds; no secondary guarantee.
9/ Excludes mortgage-backed securities backed by FHA/VA mortgages.

Table 2
MARKET SALES AND TRADING
Government Guaranteed Securities and Loans
Excluding GNMA and FHLMC Mortgage-Backed Securities

| | Maximum maturity (years) | Original issue guarantee (percent) | Change in private holdings 1/ FY 1979 | Private holdings 9/30/79 1/ | Trading volume | Trading volume | Minimum purchase size |
|---|---|---|---|---|---|---|---|
| Original issue in securities market | | | | | | | |
| Maritime Administration guaranteed-ship financing bonds | 40 | 100 | 266 | 5,703 | inactive | public offering pvt. placement | $1,000 |
| HUD-guaranteed low income | | | | | | | |
| Tax-exempt notes | 1 | 100 | 790 | 7,192 | active | auction | |
| Tax-exempt bonds 2/ | 40 | 100 | -307 | 7,858 | seldom | 2/ | $5,000 |
| HUD-guaranteed urban renewal notes 3/ | 1 | 100 | -325 | 466 | active | auction | $1,000 |
| Guaranteed portion often sold by originator | | | | | | | |
| AID worldwide housing loans | 15-30 | 100 | 80 | 760 | inactive | pvt. placement | 4/ |
| Farmers Home business and industrial loans | 40 | 90 | 618 | 1,500 | inactive | pvt. placement | 4/ |
| NOAA fishing vessel loans | 20 | 100 | 58 | 106 | inactive | pvt. placement | whole loan |
| FHA/VA mortgages | 30 | 100 | -70 | 90,295 | inactive | pvt. placement | whole loan |
| SBA-guaranteed business loans | 10-15 | 90 | 720 | 7,621 | inactive | pvt. placement | whole loan |
| Guaranteed loans usually held by originator | | | | | | | |
| Farmers Home Administration | | | | | | | |
| Operating loans | 40 | 90 | -10 | 14 | occasional | pvt. placement | whole loan |
| Emergency loans | 40 | 90 | -19 | 24 | occasional | pvt. placement | whole loan |
| Emergency livestock loans | 40 | 90 | -167 | 269 | occasional | pvt. placement | whole loan |
| Economic emergency loans | 40 | 90 | 75 | 75 | occasional | pvt. placement | whole loan |
| Rural housing loans | 40 | 90 | 12 | 12 | occasional | pvt. placement | whole loan |
| Economic Development Administration guaranteed | 40 | 90 | 636 | 883 | none | none | whole loan |
| Guaranteed student loans | 15 | 100 | 948 | 7,063 | 5/ | pvt. placement | whole loan |
| Geothermal energy loans | 20 | 100 | 1 | 14 | 6/ | pvt. placement | whole loan |
| FAA aircraft loans | 15 | 90 | -19 | 190 | none | none | whole loan |
| Export-Import Bank export credit guarantees | 1/2-46 | 100 | 1,117 | 6,586 | none | none | 4/ |
| SBA pollution control bond guarantees (tax-exempt) | 30 | 100 | 40 | 55 | inactive | pvt. placement | 4/ |

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1/ Contingent liability of the federal government.
2/ No new bonds have been issued since 1974.
3/ Program is being phased out.
4/ Project financing is divided among investors on original issue. Pieces are not divisible after original issue.
5/ Student loans usually are not sold, but can be used as collateral for repurchase agreements. Transfers are permitted among Department of Education approved servicers.
6/ Transfer to date consists of private placement with pension fund.

based on the type of obligations and on discussions with program agency officials and market participants. Currently, there is no centralized survey of the dollar volume of transactions in these obligations.

Guaranteed obligations can be classified into three general groups: (1) bond-type obligations that are financed in the market on original issue and which are traded in a secondary market; (2) loans that are originated and serviced by one entity and sold to another investor in the secondary market; and (3) loans that are originated and held by the originator. Innovations initiated by market participants and the guarantee agencies have encouraged sales of the guaranteed portion of partially-guaranteed loans into the secondary market in order to provide liquidity for the obligations and to increase the availability of credit for agency programs. The guaranteed obligations which comprise the major share of the market are described below.

## HUD Projects

Of all guarantee programs, only HUD project notes and bonds and Maritime Administration guaranteed securities are currently sold through public offerings and are issued in a standard denomination. The Department of Housing and Urban Development guarantees tax-exempt notes and bonds that are issued by approximately 3,000 local public housing finance authorities for low-income housing projects. The obligations are fully secured by HUD annual contributions contracts, under which HUD pays principal and interest on the obligations of the HFAs (42 U.S.C. 1437c). HUD also has authority to loan up to 100% of development, acquisition and rehabilitation costs to the HFAs in the event obligations are not sold in the market (42 U.S.C. 1437b). HUD has back-up authority to borrow from the Secretary of the Treasury, so that timely payment is assured.

HUD project notes are designed to provide for short-term financing during a project construction period. While the program allows for long-term bonds to be guaranteed to provide permanent financing, no long-term HUD project bonds have been issued since 1974. Thus there has been a large build-up in the amount of short-term financing that is being rolled over each year. The President's Budget for FY 1981 calls for FFB purchases of long-term HUD-guaranteed project bonds; to date the FFB has not purchased any.

HUD project notes are bellwether issues in the tax-exempt market, and are actively traded. They are sold to the public in regularly scheduled monthly auctions of approximately $1 billion in which bidders compete for the notes of specific issuers. Usually, banks and securities dealers form syndicate groups to bid on particular issues, and the notes subsequently are distributed to investors. The auction occurs approximately 1 month prior to the delivery date of the securities.

Title XI Ship Financing

The Maritime Administration fully guarantees 6-month to 40-year securities that are issued in the market by qualified American shipowners under the Merchant Marine Act of 1936, as amended (46 U.S.C. 1271 et seq.). MarAd guarantees short-term obligations maturing in 6 months to 1 year to accommodate construction or renovation period financing needs. The short-term obligations can be refinanced in separate transactions in the form of longer-term sinking fund debentures to provide for permanent financing. MarAd also guarantees long-term financing for shippers who have utilized unguaranteed loans during the construction period. The long-term sinking fund debentures are redeemed at par on a lottery basis in predetermined amounts on specified dates over the maturity period.

Title XIs usually are sold to the public through underwriters, although smaller issues often are privately placed through investment bankers who act as agent and charge a fee. The terms of all sales of MarAd Title XIs on original issue must be approved by the Treasury Department. Pricing usually takes into consideration current yields on marketable U.S. Treasury issues with similar maturities. Pricing of the Title XIs is usually done one week prior to the issue date, but can be done as much as one month prior to delivery of obligations.

Pension funds and life insurance companies, which hold rather than trade the obligations, comprise the major share of the market. Dealers who distribute the bonds on original issue also make markets in the obligations in order to provide liquidity for their customers. Individual participation in the MarAd Title XI market is practically nonexistent, with the exception of retirement funds of high-income professionals.

Small Business Loans

The second category of Federal guarantee programs in table 2 includes those in which the originator sells the whole loan or the guaranteed portion of the loan in the secondary market and usually retains the responsibility for servicing the whole loan. By far the most important of the guaranteed loans in this category are the fully-guaranteed portions of SBA business loans that are partially guaranteed on origination (SBA 90-10s).

Section 7 of the Small Business Act (15 U.S.C. 636) authorizes SBA to participate in loans to qualified small businesses, on an immediate or deferred basis, for up to 90% of the principal and interest. The general powers in Section 5(b) of the Act (15 U.S.C. 634(b)) have been interpreted in legal opinions by the SBA, the Attorney General and the Comptroller General to authorize SBA to pledge the full faith and credit of the U.S. to repayment of the fully guaranteed portion of a loan, whether it is held by the loan

originator or a secondary investor. The SBA does not under current law, however, have authority to guarantee participation certificates in pools of SBA guaranteed loans. The SBA pledges that, in the event it is called upon by the holder to make good on its guarantee, it will draw on revolving funds authorized under the Act and seek additional appropriations if necessary.

The overwhelming share of SBA-guaranteed loans and of guaranteed loans that are sold in the secondary market are small business loans guaranteed under section 7(a). Those loans generally mature in up to 10 years, with monthly amortization of principal and interest over the term of the loan (other amortization schedules can be agreed upon) and no prepayment penalty. The average loan size is $110,000 while the maximum loan guarantee is $500,000 to any one borrower. There are $7.6 billion of guaranteed small business loans outstanding at the end of fiscal year 1979. About 15 to 20 percent of the $3.1 billion of new loans estimated to be guaranteed in the current fiscal year are expected to be sold in the secondary market.

The interest rate on an SBA-guaranteed business loan can be fixed or variable. The interest rate on a fixed rate loan is set for the term of the loan at a maximum of the commercial bank prime rate at the time the loan is disbursed, plus 1/2 of 1 percentage point. The maximum allowable on variable rate loans is the base rate (usually the prime rate) plus 2-1/4 points for loans maturing in 7 years or less or 2-3/4 points for loans maturing in more than 7 years. The rate on a variable rate loan can change only at the end of each 3-month period following the date the loan is disbursed, and is based on the commercial bank prime rate at the end of the period. SBA regulations permit lenders to require guaranteed borrowers to pay the 1-time, 1 percentage point SBA guarantee fee when the loan is disbursed. Both fixed rate and variable rate loans are sold in the secondary market.

Repayment schedules on SBA guaranteed business loans are negotiated between the lender and the borrower, but generally provide for monthly payments of principal and interest. The level debt service and the level installment methods of repayment are most often used. Level debt service is the most popular and provides for equal monthly payments, like a home mortgage, with each payment applied first to interest and the rest to principal. The level installment method provides for equal monthly installments of principal plus interest on the remaining balance.

Commercial banks are originators of practically all small business loans, with about 800 banks participating actively in the program. SBA also licenses small business lending companies, which are regulated by state banking commissions, to make SBA guaranteed loans in geographical areas where the SBA believes support of other lenders is inadequate. In January 1980, SBA for the first time authorized a finance company which relies on the commercial paper and bond markets for its financing, to become a lender in the Section 7 program. The finance company plans to sell the guaranteed portion of its loan production through dealers in U.S. government securities.

SBA has promoted the development of a secondary market in the fully-guaranteed portion of small business loans, in order to increase the flow of funds available to guaranteed borrowers. The secondary market was made possible in 1974, when SBA obtained a Comptroller General's opinion stating no objection to SBA purchases of the guaranteed portion of loans from innocent holders even when the borrower has not gone into default, regardless of any fraud or misrepresentation by the lender. The secondary holder is in a somewhat better position to collect from SBA than the originator, since the originator's ability to collect is conditioned on its performance as servicer.

In 1979, SBA contracted with a fiscal and transfer agent to act as custodian of the documents behind the guaranteed portion of the small business loan, to issue one certificate per loan, to maintain a central registry of holders of record of certificates, and act as a central receiving and paying agent. The agent is not a market maker. SBA guarantees that the fiscal and transfer agent will pass through payments from the borrower or SBA. Loans that were outstanding prior to initiation of the certificate system can be converted into certificates, at the request of the purchaser, upon execution of an agreement with the lender/servicer and SBA.

The guaranteed portions of SBA business loans are sold by the originator to a regional or national securities dealer, while the originator holds the nonguaranteed portion and services the whole loan. The interest rate that the SBA-guaranteed borrower pays is substantially higher than the yield to the secondary market investor who purchases the guaranteed portion of the loan. In lieu of paying a premium on the loan, which would adjust the yield to current market yields and which would be at risk in the event of prepayment of the loan, the investor usually pays a small premium and pays a monthly fee to the originator/servicer of the loan. The fee is retained by the servicer who receives loan payments from the borrower and passes them through to the investor.

The combination of the face interest rate on the loan, plus the servicing fee raises substantially the originator/servicer's yield on its invested capital. With a 15% interest rate on the loan and 1% servicing fee, for example, the gross return on invested capital would be roughly 24% (15% on the 10% unguaranteed portion, plus 1% on the 90% guaranteed portion).

The originator often sells the guaranteed portion as much as 30 days in advance of the loan closing date. Contracts for sales of the guaranteed portion usually include an escape clause to provide for the event that the loan is not funded or an SBA guarantee could not be obtained in time for the schedule closing date. Unlike forward sales of GNMA passthroughs, other guaranteed SBA loans usually are not substituted to fill the commitment to deliver a guaranteed portion of an SBA loan. This absence of substitutions reflects the discrete terms of each guaranteed loan and the unwillingness of investors to buy obligations of particular businesses or types of businesses.

The SBA has proposed legislation that would permit pooling of the guaranteed portions of several loans (including old outstanding loans) and sales of participation certificates, which would be guaranteed by SBA. Currently, the guaranteed loans are not divisible into smaller denomination pieces, and each SBA guaranteed loan certificate is backed by documents for a specific small business loan.

The SBA does not have centralized recordkeeping system for outstanding SBA-guaranteed loans, which would provide up-to-date information on the unpaid principal balance of guaranteed loans. Thus, there are no data, which would be analogous to the GNMA pool factors, for the investor to check prior to purchasing an SBA-guaranteed loan in the secondary market. The SBA guarantees the correctness of the principal amount of a loan only on the date of disbursement. It does not guarantee the correctness of information on current principal balances over the loan amortization period, and the investor's most reliable source of that information is the originator of the loan.

The secondary market for SBA-guaranteed loans is focussed mainly on insurance companies and pension funds, which are attracted by the high yield and safety of the instruments. The SBAs are also attractive investments for deposit-type institutions since they can be used to meet most pledging requirements. There is little participation by individuals. While the buyers of SBAs usually hold them, dealers that distribute SBAs make markets to provide their customers with liquidity. Generally, SBA guaranteed loans are priced taking into consideration current trading in GNMA pass-through securities whose amortization schedules are similar to SBAs.

## Farmers Home Business and Industrial Loans

The Farmers Home Administration guarantees 90% of the outstanding principal and accrued interest on rural business and industrial loans under the Rural Development Act of 1972 (7 U.S.C. 1932(a)). Guaranteed business and industrial loans outstanding totaled $1.5 billion at the end of fiscal year 1979.

The FmHA B&I loan guarantee program is designed to promote business and employment in areas with less than 50,000 population. Unlike the requirements of the SBA business loan guarantee program, borrowers need not demonstrate an inability to obtain credit without a guarantee and there is no statutory or regulatory maximum on the size of loans guaranteed for any one borrower. Whereas the average size of an SBA guaranteed loan is $110,000, FmHA B&I loans average around $500,000.

The interest rate on a B&I loan is negotiated between the lender and the borrower, can be fixed or variable, and is not subject to any maximum. Different interest rates can be set on guaranteed and the nonguaranteed

portions. Maximum maturities are 7 years for operating loans, the shorter of 15 years or useful life for equipment loans, and 30 years for real estate. One all-purpose loan can be made, so long as the amortization schedule accommodates the maximum maturity for each purpose. Usually payments of principal and interest are made monthly in level installments, but other terms can be arranged.

Nearly all B&I loans are sold into the secondary market. Farmers Home requires the originator/servicer to hold only 5 percent of the loan; that is, half of the nonguaranteed portion. On original sale in the secondary market the guaranteed portion of a B&I loan can be divided into up to 10 notes, each of which is guaranteed by FmHA and each of which can have a separate interest rate and maturity schedule. Subsequent divisions of guaranteed notes are not guaranteed, nor would certificates representing participations in a pool of FmHA B&I loans be guaranteed. The nonguaranteed portion can be sold in the form of only one note.

Sales of the guaranteed portions of B&I loans in the secondary market are similar to secondary market sales of SBAs, except that the FmHA has not contracted with a fiscal and transfer agent to facilitate trading and recordkeeping. FmHA does not have centralized data on the outstanding balances of particular loans, so that the best source of that information is the originator/servicer.

## AID Worldwide Housing

The Agency for International Development fully guarantees loans, which are held by investors in the United States, to finance housing projects in developing countries as part of the U.S. Foreign Assistance Program (22 U.S.C. 2181 *et seq.*). Since its beginning in the 1960s, more than $1.2 billion of loans have been authorized for 137 projects in 36 countries and to 3 regional institutions. At the end of fiscal year 1979, there were $760 million of A.I.D. guaranteed housing loans outstanding.

Lenders under the A.I.D. program must be U.S. entities. A.I.D. assists prospective borrowers in soliciting bids from a wide range of investors by publishing a notice of each A.I.D. guaranteed investment opportunity in the *Federal Register* and by mailing notices to interested firms and individuals. The interest rate on A.I.D. guaranteed loans is a maximum of 1 percentage point above the then current FHA ceiling rate for similar domestic loans. A.I.D. charges a 1-point guarantee fee on the unpaid principal amount and the investor can charge a 1-point commitment fee up front.

While A.I.D. requires amortization of principal over the life of the loan, A.I.D. permits the parties to contract for a grace period of up to 10 years on the repayment of principal. The maximum maturity period for any

guaranteed loan is 30 years. Prepayments on guaranteed loans are made without penalty.

A.I.D. has contracted with a fiscal agent to collect all loan payments from borrowers and pass them through to holders of record. A.I.D. has had a longstanding arrangement under which District Federal Home Loan Banks, notably of Boston and New York, have originated A.I.D. guaranteed housing loans and have sold participations in those loans to savings and loan associations. The A.I.D. fiscal agent does not make distributions of loan repayments to subsequent holders; these distributions are made by the FHLB that originated the loan.

In a recent development, A.I.D. has contracted in two separate transactions to guarantee loans originated by large commercial banks. These banks sell participations in the guaranteed loans to secondary holders, mostly savings and loans, and pass through loan payments on a pro rata basis. A.I.D. is a party to each note that is executed with a secondary market investor by the commercial bank originator, thus guaranteeing the secondary holder. There is no minimum denomination for the notes. The guarantee does not extend to subsequent holders.

## NOAA Fishing Vessels

The National Marine Fisheries Service of the National Oceanographic and Atmospheric Administration, U.S. Department of Commerce, fully guarantees loans for fishing vessels that are owned by U.S. citizens. While statutory authority for fishing vessel loan guarantees is under Title XI of the Merchant Marine Act of 1936, as amended (46 U.S.C. 1271-1280), the fishing vessel guarantee program is administered separately from the MarAd Federal Ship Financing program (50 C.F.R. 255).

NOAA has the authority to guarantee interim construction loans and long-term loans, but currently only guarantees the long-term permanent financing for new, reconstructed or reconditioned fishing vessels. NOAA issues commitments to guarantee the permanent financing at the beginning of a fishing vessel construction, reconstruction or reconditioning project. When a vessel is delivered, the proceeds of the guaranteed loan are used to repay unguaranteed interim financing.

Several securities dealers currently are active in assisting owners to obtain financing packages which include arranging unguaranteed interim financing and placing the long-term guaranteed obligations with investors. A typical package could include short-term financing by a commercial bank and placement of the long-term debt with a pension fund. Pension funds comprise a large proportion of the market for this paper, while savings and loans, Production Credit Associations and bank trust departments are also investors.

The maximum maturity of fishing vessel loans generally is 20 years or the useful life, whichever is shorter. There is no maximum dollar amount of loans that can be guaranteed; the average size is around $300,000. The interest rate on the guaranteed loan is negotiated between borrower and lender, and is not subject to any ceiling. The guaranteed obligation is in the form of a promissory note that represents the whole loan; NOAA does not permit the loans to be divided into smaller pieces. In addition, regulations require NOAA approval before the guaranteed obligations can be assigned.

## Loans Held By Originator

The third category of guaranteed loans which are financed currently in the private markets includes those that usually are held by the originator. This category includes fully-guaranteed student loans, which can be sold as whole loans to other lenders whose ability to provide for servicing has been approved by the Department of Education. The extremely large amount of servicing required for a guaranteed student loan, especially when it is in repayment status, limits the investment appeal of this paper. Commercial banks originate the majority of student loans, though originations by tax-exempt state and local student loan funding enities have been growing in recent years. The Student Loan Marketing Association was established as an off-budget federally sponsored agency in 1972 to be a secondary market for guaranteed student loans. SLMA holds practically all of the student loans it purchases and finances its activities by borrowing solely through the Federal Financing Bank. SLMA borrowings are guaranteed by the Department of Education.

The buy-and-hold category also includes the economic development loan guarantee program of the Economic Development Administration and the aircraft loan guarantee program of the Federal Aviation Administration. Each of these programs guarantees 90% of principal and interest on loans. Unlike the SBA and FmHA 90-10 programs, however, neither EDA nor FAA guarantees extend to a secondary holder.

# CHAPTER IV

## REVIEW OF CASES OF ABUSIVE TRADING PRACTICES IN MARKETS FOR GOVERNMENT RELATED SECURITIES AND OF REGULATORY MEASURES TO REDUCE SUCH PROBLEMS

The federal securities laws apply, among other things, to the original distribution of securities, and the trading of already issued securities. The Securities Act of 1933 ("1933 Act") seeks to ensure effective disclosure in the original distribution of corporate securities by mandating that specific documents be given to investors and filed with the Securities and Exchange Commission ("SEC"). 1/ To complement this system of specifically mandated disclosures by issuers, the 1933 Act has a broad anti-fraud provision, Section 17(a), which applies to the offer or sale of any security, whether or not subject to the Act's registration requirements.

The trading of already issued securities is generally covered by the Securities Exchange Act of 1934 ("1934 Act"), which contains provisions on both the disclosure of information and the substantive conduct of broker-dealers as well as other participants in the securities markets. Like the 1933 Act, the 1934 Act has a general anti-fraud provision, Section 10(b), which applies to the purchase or sale of any security by any person. At the same time, the 1934 Act establishes specific standards of conduct and prophylactic measures through a combination of self-regulation and direct rulemaking by the SEC. Congress charged the securities exchanges in 1934 and the National Association of Securities Dealers ("NASD") in 1938--referred to as self-regulatory organizations ("SROs") 2/--with the primary responsibilities for the conduct of

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1/ Sections 5 and 10 of the 1933 Act.

2/ Other SROs include the Municipal Securities Rulemaking Board and registered clearing agencies.

their respective members. But the authority of SROs is subject to the SEC's supervision. For example, under Section 19(b) of the 1934 Act, SROs must file all proposed rule changes with the SEC, which must take affirmative action to approve or disapprove most such proposed rule changes. 3/ And, under Section 19(d) of the 1934 Act, the SEC is authorized to review any final disciplinary sanction imposed by an SRO upon a member. Moreover, Congress empowered the SEC to engage in direct rulemaking with respect to various trading practices, such as short-selling, 4/ and various aspects of broker-dealer operations like financial responsibility. 5/

Although government related securities are subject to the aforementioned anti-fraud provisions of the 1933 Act and the 1934 Act, the majority of the Acts' requirements do not apply to such securities. The 1933 Act exempts government related securities from the registration requirements of that Act. 6/ Similarly, the 1934 Act effectively exempts broker-dealers trading solely in government related securities from most SRO and SEC rules governing the conduct of securities trading. The dealer registration provisions of the 1934 Act, for example, allow unregistered dealers to trade in these exempted securities; 7/ and the recordkeeping provisions are applicable only to registered brokers,

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3/ See also Section 19(c) of the 1934 Act.

4/ Section 10(a) of the 1934 Act.

5/ Section 15(c)(3) of the 1934 Act.

6/ Section 3(a)(2) of the 1933 Act.

7/ See Section 15(a)(1) of the 1934 Act, together with that Act's definition of "exempted security" in Section 3(a)(12).

dealers, municipal securities dealers, and certain other specified persons. 8/

As mentioned above, 9/ Congress exempted government related securities from most of the regulatory provisions of the federal securities laws largely because of the federal guarantee of interest and principal. However, no government guarantee can protect against the risk of substantial price swings and attendant liquidity impairment resulting from sharp changes in interest rates. This risk is most pronounced in the market for mortgage-backed securities, which are long-term obligations commonly bought or sold for delivery four to six months into the future without any margin requirement. Moreover, a number of other factors have added to the potential for problems in government related securities, especially relating to forward trading in mortgage-backed securities:

(1) the significant changes in the economic environment for government related securities;

(2) a marked increase in the volume of government related securities sold to the public;

(3) smaller, less sophisticated institutions and individuals increasing their participation in these markets; and

(4) a substantial number of new and relatively small dealers participating in the government related markets.

Of course, problems have not materialized in a large proportion of the trades in government related securities. As indicated above, 10/ the trading markets for such securities involve approximately $300 to $500

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8/ Section 17(a)(1) of the 1934 Act.

9/ See Chapter II, *supra*.

10/ See Chapters II and III, *supra*.

billion on an annual basis. And, while precise statistics are not available, it appears that the great majority of these trades have been conducted in an open, honest manner by investors, dealers and issuers. Nevertheless, there have recently been a disturbing number of reported cases involving serious abuses in the trading of government related securities. Most of these cases involve mortgage-backed securities--most importantly GNMA securities and to a lesser extent FHLMC securities.

Below we summarize the major abuses that have occurred in the trading markets for government related securities during the past five years. In the light of these abuses, we then review the regulatory measures imposed on registered broker-dealers trading in non-exempted securities and the possible application of such measures to trading in government related securities, and the regulatory measures voluntarily adopted by certain dealers trading in government related securities.

## Extent of Abuses

During the last five years, the SEC has instituted a number of enforcement proceedings and investigations involving government related securities. Appendix A presents summaries of 28 such cases and investigations. These include the SEC proceedings that have been completed during the last five years, and other proceedings and investigations for which a substantial amount of information is available. Not included are other SEC investigatory proceedings at preliminary stages of development. Moreover, the press has recently issued reports on at least four other government related securities cases involving significant sums.

While some of the 28 cases in the Appendix involve a variety of securities and different types of abuses, the cases can be grouped into several major categories. Of the 28 cases, 23 involve primarily government related mortgage-backed securities, two cases involve other government related securities, and three cases involve Treasury securities. Of the 23 cases concerning government related mortgage-backed securities, 16 primarily involve overcommitments in connection with forward transactions, three principally involve misuse of customer funds or securities, and the remaining four involve various problems such as churning, adjusted trading, and interpositioning. Of the 16 overcommitment cases, investors became over-committed at least in part because of questionable sales practices of dealers in seven, investors became overcommitted as a result of their own speculation in three, and dealers themselves became overextended or suffered related financial problems in six cases.

Unregistered dealers were the main cause of the problems in 10 of the cases; in nine cases dealers registered with the SEC were involved in abusive conduct. Four cases involved both registered dealers and unregistered affiliates. The problems in the remaining cases were caused by a mortgage banker, a financial officer of a university, and others. While no firm figures concerning the total losses resulting from the 28 cases are available, it is estimated that those incurred by customers of dealers trading in GNMAs were \$70-94 million while dealers absorbed an additional \$15 to \$17 million in losses. To the extent that further breakdowns can be made, it appears that between \$53 million and \$77 million of losses have occurred in cases involving unregistered broker-dealers, while between \$7 and \$14 million of losses have occurred in cases involving registered broker-dealers.

In addition, the press has recently reported at least four other cases involving significant losses in connection with GNMA forward commitments. These cases involve two savings and loan associations, a mortgage banker, and a governmental jurisdiction. One savings and loan with assets of about $233 million has filed suit against 11 brokerage firms alleging, among other things, that the brokerage firms sold it "hundreds of millions of dollars" in "grossly unsuitable" GNMA forward transactions. 11/ The Federal Savings & Loan Insurance Corporation ("FSLIC"), in order to protect $175 million in customer deposits, recently took over another savings & loan that was unable to meet its extensive GNMA forward commitments. The FSLIC has already paid almost $80 million for GNMA forward commitments, and the savings and loan still has outstanding commitments to buy $500 million in GNMAs--almost three times its total deposits--through mid-1981. 12/ In the third case, a county fund refused to take delivery of $20 million in GNMA forwards, thus avoiding a $3 million loss, and sued its former treasurer and a broker-dealer to recover $5.5 million in losses allegedly suffered as a result of unauthorized and illegal trades. 13/ And, a mortgage banker with extensive GNMA forward and futures commitments is engaged in litigation with at least 3 broker-dealers over several million dollars allegedly lost as a result of speculative activity in these markets by several of the mortgage banker's principals. 14/

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11/ Wall Street Letter, Feb. 25, 1980, at 1.

12/ Wall St. J. March 26, 1980 at 16.

13/ Business Week, March 10, 1980, at 44.

14/ *See*, e.g., Barrons, Nov. 12, 1979 at 4.

Furthermore, interviews with state regulators and federal agencies 15/ indicate that there have been many other instances in which financial institutions have suffered significant losses in trading government related securities. These problems have typically occurred at small banks, savings and loan associations, and credit unions. While the sharp increase in interest rates in recent years has contributed greatly to liquidity problems, a substantial number of such institutions have lost large sums, relative to their resources, in transactions that were ill-suited to their financial positions and needs. The most common cause of these problems has been the acceptance of relatively large forward commitments for mortgage-backed government related securities without full appreciation of the risks associated with increases in interest rates. Sharp or high-pressure sales practices by certain dealers have contributed to these problems in the first instance; then in many cases complex financing and accounting schemes have been used in attempts to cover-up the difficulties and postpone recognition of the losses.

Below is a review of the major categories of abuses revealed by the SEC cases in Appendix A. Citations, by case number, to Appendix A are provided where appropriate for illustration. In a number of cases more than one abuse was present, so some cases are cited in several categories. This review also draws upon the aforementioned interviews with various government regulators and market participants.

## Overcommitments

The most dangerous problem to date in the market for mortgage-backed, government related securities has been the assumption of large forward delivery

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15/ See Appendix B for a list of the persons, firms, and agencies interviewed in connection with this report.

commitments by institutions and individuals without sufficient assets to enter into such risks. In some cases, over-commitments by relatively unsophisticated investors have been encouraged by dealers, frequently through the use of sales tactics like those described below. In other instances, however, apparently sophisticated investors such as mortgage bankers have made conscious decisions to speculate in government related mortgage-backed securities and have assumed patently excessive positions while concealing the full extent of their commitments from the dealers involved. For example, one mortgage banker speculating in GNMA forwards told each of 10 to 12 dealers that it had made no commitments with any other dealer or was dealing with only one or two other dealers. In fact the mortgage banker, which had a net worth of approximately $2 million, had substantial commitments with each of the 10 to 12 dealers, had commitments exceeding $50 million with each of three, and had acquired net "long" commitments of over $350 million coming due over the following five months. (See, e.g., cases 1, 4, 8, 9, 10, 11, 19, 21, 25, 26.)

In several cases, dealers themselves have become over-committed, and this has led to their bankruptcy, with accompanying defaults on their commitments to customers and to other dealers. In other cases, customer defaults led to serious financial problems for the dealers that had sold the forward commitments. (See, e.g., cases 2, 4, 7, 13, 14, 17, 19, 28).

A fundamental factor conducive to the over-commitment problems experienced in government related mortgage-backed securities has been the absence of margin requirements. The lack of such restrictions has allowed excessive leveraging and speculation in forward commitments for these securities. Likewise, the absence

of such restrictions has enabled investors to use repurchase agreements as a device to "pyramid" holdings--that is, an original investment in government related securities serves as collateral for an entire series of additional purchases by the same investor. In either case, a significant rise in interest rates can create large unrealized losses on the transactions. (See, e.g., cases 2, 4, 9, 14, 19, 21.)

Sales and Trading Practices

Unsuitable recommendations and transactions. Closely related to the problem of over-commitments is the problem of dealers making recommendations to their customers that are unsuitable in view of the interest rate risks associated with the trading of government related securities and the financial circumstances and objectives of the investors. In most cases, unsuitable transactions involved forward commitments--either mandatory or "stand-by"--to purchase GNMAs. The investors have often been small institutions such as banks, savings and loans, other thrift institutions, and credit unions, but other entities such as universities, local governmental units, and individuals have also participated in clearly unsuitable transactions. All of the regulatory agencies interviewed in connection with this study agreed that unsuitable recommendations and sales have been a major factor behind the problems in forward trading of government-guaranteed securities. (See, e.g., cases 1, 4, 11, 13, 14, 15, 19, 25).

Among the examples described in Appendix A, one dealer sold forward commitments to purchase $5 million worth of GNMAs to a credit union with total assets of only $1 million and sold $21 million in commitments to a bank with total assets of $11 million. In another case, a salesman placed well over a million dollars worth of GNMA forward commitments in the account of an individual

who had a very small net worth and who had asked to be informed immediately if losses reached $2,500. (See, e.g., cases 4, 7; cf. case 10.)

<u>High-pressure sales methods and inadequate disclosure</u>. Many of the unsuitable transactions and positions evident in government related securities have resulted from use of high-pressure sales tactics and inadequate disclosures by dealers and salesmen. These sales methods have been used with respect to both individuals and small, institutional investors. Polished presentations stressing large returns, with little or no initial cash expenditure, have commonly been made, in some cases through "cold calls" to persons or institutions listed in directories but otherwise unknown by the salesman. Moreover, certain dealers have misrepresented their own financial conditions to prospective investors, and one unregistered government securities dealer falsely held itself out as registered, a member of the NASD, and insured by the Securities Investor Protection Corporation. (See, e.g., cases 4, 10, 13.)

Some salesmen have omitted information that repeated GNMA trades in a customer's account can substantially reduce or eliminate the return that could otherwise be expected. There are also cases in which dealers, in selling forward commitments, have neglected to mention the large losses that investors can sustain on these forward commitments if interest rates change. In some cases, salesmen have even extended assurances that buyers would not have to take delivery of the subject GNMAs but could sell the contract at a profit at the settlement date, finance the purchase, or extend the commitment. Other salesmen have also told financial institutions that they could increase their current reported earnings by taking into current income fees from writing stand-by commitments, even though this constitutes a questionable or improper accounting practice and even though

such commitments entail major risks. (See, e.g., cases 4, 7, 13, 14, 21, 22, 25.)

Pricing, churning, unauthorized sales, delayed settlements. Certain salesmen and dealers have also engaged in other questionable sales practices in government related securities trading. In some cases dealers have charged excessive mark-ups and mark-downs or excessive and unexplained interest charges on customer accounts. And, at least in a few instances, dealers have engaged in churning of customer accounts, thereby inflating their own profits and commissions at the customers' expense. In other cases dealers and salesmen have carried out purchases and sales for customer accounts without customer authorization, sometimes utilizing false or misleading confirmations in the process. In at least one other case, it appears that the settlement dates on cash purchases of GNMAs by individual customers were delayed, which may have resulted in customers losing one or two months of principal and interest payments on the securities they purchased. (See, e.g., cases 1, 4, 8, 9, 15, 18, 20, 21, 25.)

## Disguising Losses and Overcommitments

After losses and over-commitments have been incurred in connection with government related securities trading, some dealers and investors have engaged in other transactions that, together with associated accounting practices, served to disguise either existing losses or the inability of an entity to carry out its contractual commitments. One practice used for these purposes is "adjusted trading," in which an investor, typically a financial institution, sells securities to a dealer at a price above the current market and agrees to purchase other securities at a similarly inflated price either concurrently with the sale or at a future date.

The effect of these transactions is to inflate the book value of the investor's portfolio and similarly inflate its current earnings or reduce its reported losses. One bank and its holding company, for example, engaged in three types of "adjusted trading" in several varieties of government related and securities to hide substantial trading losses. These falsely reported transactions were made possible by the cooperation of a dealer bank and two other dealers. Savings and loans, credit unions, trust companies, banks, and even governmental entities have made use of transactions of this sort to hide a variety of losses. (See, e.g., cases 6, 10, 16, 21, 22.)

Repurchase agreements and reverse repurchase agreements 16/ of government related securities have also been used for the purposes of disguising losses or covering a purchaser's inability to pay for securities it had agreed to buy. Such arrangements have been especially common in connection with GNMA forward commitments that show substantial losses to the purchasers at the time of settlement. In a few instances, dealers have represented to their customers at the time they entered into forward contracts that they could relieve them of any potential losses at settlement by arranging repurchase or reverse repurchase transactions on favorable terms. (See, e.g., cases 4, 14, 21; cf. case 9).

Misuse of Customer Funds and Securities

Several of the cases in Appendix A reveal misuse by dealers of customer funds or securities in connection with the trading of government related securities. In some of these cases, unregistered dealers sold or hypothecated securities that

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16/ See the discussion at pages 24-27, *supra*, explaining the nature and operation of repurchase and reverse repurchase agreements.

belonged to their customers or lenders, causing losses to the customers and lenders when the dealers became insolvent. In other cases, unregistered dealers have used newly received funds from investors to finance their commitments to purchase or repurchase securities from other investors. (See, e.g., cases 3, 7, 10, 13, 14, 17, 26).

In several other known cases, dealers have persuaded customers to enter into claimed "repurchase agreements" or other forward transactions in which there were actually no underlying securities. Accordingly, while denominated "repurchase agreements" or "standby with pair-off" trades, these transactions were in fact unsecured loans to the dealers. In some instances, these commitments were subsequently rolled-over and enlarged, all without any collateral being established. Two known cases involved the use of false confirmations to further convince the customers that the fictitious repurchase agreements or forwards were genuine. (See, e.g., cases 3, 10, 12, 13, 14).

## Training and Supervision

Investigations in several cases have revealed serious inadequacies in the training and supervision of salesmen by dealers. In one case, an unregistered dealer developed a large business in government related securities using at least 15 salesmen with no prior experience in those securities. Nevertheless, the dealer firm provided no meaningful rules, guidelines, or training in fair and appropriate sales practices. What little instruction the firm did supply encouraged the salesmen to employ trading practices, such as churning of accounts, designed to inflate firm profits and salesmen's commissions at the expense of the customers. (See, e.g., cases 4, 7, 21).

Industry observers have indicated that major shortcomings in both training and firm supervision of sales practices have been chronic at some unregistered dealers. These shortcomings are especially serious where salesmen are given high commission rates and therefore have a heightened incentive to employ high-pressure sales methods and to make inadequate disclosure to customers. In fact, compensation to individual salesmen as high as 40% to 45% of the total firm commissions or markups on their sales have been utilized in government securities firms, and salesmen at certain firms have achieved extremely large earnings from these commissions. In the case cited in the preceding paragraph, at least 10 salesmen at an unregistered dealer each earned over $40,000 in net commissions during a single month. (See, e.g., cases 4, 10, 13, 15).

Recordkeeping

Finally, investigations of a number of dealers have revealed major shortcomings in recordkeeping. In various individual cases, dealer records have been so deficient as to (1) render impossible an assessment of a firm's financial position over substantial periods of time by an accounting firm subsequently retained by the firm's receiver; (2) make it impossible for a firm to calculate its own capital position; (3) fail to indicate whether a firm acted as principal or agent in certain customer purchases that were not completed because of defaults by the initial selling party; (4) leave doubt whether certain trades subsequently disclaimed by customers were in fact authorized or unauthorized; or (5) leave doubt as to whether or not a firm actually purchased the government related securities it had represented would underlie the investment packages it sold to investors. (See, e.g., cases 2, 7, 9, 12, 17, 20, 23).

## Possible Regulatory Measures

The SEC and the SROs have applied various types of regulatory measures to reduce the incidence of trading abuses with respect to non-exempted securities. Although these requirements generally do not apply to government related securities, some dealers in such securities have implemented, on a voluntary basis, similar measures. Moreover, in the course of the interviews and discussions for this study, these and other measures have been suggested as desirable or appropriate in connection with the trading of government related securities. In the following pages we describe major categories of regulatory measures and their possible application to the markets for government related securities. These measures, if in place at the time, would have likely deterred or reduced the incidence of abuse outlined above, although these measures would of course not have totally eliminated fraud or deceit. 17/

### Standards of Financial Responsibility

Standards of financial responsibility are imposed on registered brokers and dealers by the SEC, the Federal Reserve Board, and SROs. Their purposes are at least three-fold: (1) ensuring that brokers and dealers are financially sound and that they operate in such a way as to protect their assets and the funds and

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17/ The following discussion is written in terms of applicability to "dealers," which term refers to both broker-dealers registered with the SEC pursuant to Section 15(b) of the 1934 Act and bank municipal securities dealers registered pursuant to Section 15B(a) of the 1934 Act ("bank dealers"). The rules applicable to municipal securities brokers and municipal securities dealers are established by the Municipal Securities Rulemaking Board (the "MSRB") and unless otherwise noted herein, are applicable to bank dealers. Some of the SEC's rules are also applicable to bank dealers in municipal securities. Certain aspects of regulation of bank dealers, as discussed herein, are performed by the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation (the "federal bank regulatory authorities").

securities held by them for customers; (2) preventing excessive use of credit for speculative purchases of securities and thereby promoting stability in the securities markets and in the nation's economy; and (3) protecting customers from becoming financially over-commited. 18/

Margins. Margin requirements establish a minimum amount of cash or securities that must be deposited or maintained as collateral in the purchase of securities on credit, or must be posted as deposits by parties to open contracts to ensure performance of their commitments. There are two types of margin: initial margin and maintenance margin. 19/ Initial margin requirements provide that the purchaser of securities must pay or deposit at least a certain percentage of the purchase price of the securities. 20/ Maintenance margin refers to the amount of

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18/ See, e.g., Don D. Anderson & Co. v. Securities and Exchange Commission, 423 F.2d 813, 816 (10th Cir. 1970) (net capital); S. Rep. No. 792, 73d Cong. 2d Sess. 3 (1934) (margin).

19/ Section 7 of the 1934 Act grants the Federal Reserve Board (the "FRB") the authority to set both initial and maintenance margin requirements for non-exempted securities. The FRB establishes initial margin requirements, but has chosen not to impose maintenance margin except with respect to options. See 12 CFR 220.8(j). It has issued the following regulations concerning margin: Credit by Brokers and Dealers (Regulation T), Credit by Banks for the Purpose of Purchasing or Carrying Registered Stock (Regulation U), Securities Credit by Persons Other than Banks, Brokers, or Dealers (Regulation G), and Rules Governing Borrowers Who Obtain Securities Credit (Regulation X).

Municipal securities are exempted securities for the purposes of Section 7 and, therefore, bank dealers' transactions in municipal securities are not subject to the FRB margin rules.

20/ Regulation T allows broker-dealers to extend the allowable amount of credit on exchange-listed securities and certain securities traded over-the-counter (OTC margin securities). Broker-dealers cannot extend credit on OTC securities that are not OTC margin securities.

money or securities required to be maintained in the account of a customer who has purchased securities on margin. Under these requirements, the amount of cash or securities collateralizing the loan or securing the commitment must be maintained at a certain level. 21/ As the market value of a security fluctuates, the dealer, for example, must "mark-to-market" the security and either credit the customer's account for the excess margin or require an additional maintenance margin payment. In the event the customer fails to respond to this "margin call" with an additional margin payment, the dealer is obligated to sell all or part of the collateral or the security and, after deducting any amount due the dealer, to remit any remaining proceeds of the sale to the customer.

Net capital. The SEC's net capital rule establishes minimum amounts of liquidity that must be maintained by dealers registered with the SEC. 22/ It is designed primarily to ensure that firms have sufficient liquidity at all times to cover their current indebtedness to all customers, and are therefore able to satisfy customers' claims for cash or securities. The term "net capital" means net worth of a dealer (i.e.) assets less liabilities) less illiquid assets, and less a discount from the market value of the securities in the account of the dealer ("haircut"), plus certain subordinated liabilities.

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21/ Maintenance margin rules are set by exchanges and other self-regulatory organizations. See, e.g., Rule 431, NYSE Guide (CCH) ¶2431; Rule 12.3 CBOE Guide (CCH) ¶2373.

22/ Rule 15c3-1; 17 CFR 240.15c3-1. The financial safety and soundness of federally chartered or federally insured bank dealers are subject to regulation by federal bank regulatory authorities; accordingly, bank dealers are not subject to the SEC's net capital requirements.

Reserve, segregation, and hypothecation requirements. An SEC rule establishes reserve and segregation requirements for registered dealers which (1) limit the use of customers' funds by dealers in their business, and (2) require dealers to obtain and maintain physical possession or control of all fully paid and excess margin securities carried in the accounts of customers. 23/ The rule also requires a dealer to deposit that portion of the customer funds held by it and not used in connection with other customers' accounts in a special reserve bank account for the exclusive benefit of customers. 24/ A separate rule limits the circumstances under which dealers may hypothecate customer securities. 25/ These rules are designed to safeguard customers' funds and securities and prevent unsound use of customers' assets by ensuring that such funds and assets are deployed in safe areas of the broker-dealer's business.

Securities Investor Protection Corporation. In 1970, Congress established the Securities Investor Protection Corporation ("SIPC"). With certain limited exceptions, all brokers and dealers registered pursuant to Section 15(b) of the 1934 Act are required to be members of SIPC. In the event that the SEC or an SRO determines that a SIPC member subject to its regulation is in or approaching financial difficulty, it is required to notify SIPC immediately. If SIPC determines that the member has failed or is in danger of failing to meet its

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23/ Rule 15c3-3, 17 CFR 240.15c3-3.

24/ Rule 15c3-3(e), 17 CFR 240.15c3-3(e).

25/ Rule 8c-1, 17 CFR 240.8c-1.

obligations to customers, and certain other conditions exist, 26/ it may apply to federal court for a decree to appoint a trustee to distribute any customer cash and securities held by the member to the customers. A special SIPC fund supported by member assessments exists to allow prompt payment of these funds and securities, subject to certain dollar limitations.

Application to government-guaranteed securities. Of the various regulatory measures that have been proposed for the trading of government related securities, margin requirements for forward commitments in mortgage-backed securities seem to be the most needed. Two principal benefits could be expected from margin requirements in forward trading of such securities. First, depending on the details of the requirements, they would protect dealers and other forward market participants against losses should the parties with which they have contracted prove unable or unwilling to fulfill their commitments. Second, by requiring at least some initial commitment of capital and additional payments to cover unrealized losses from market movements, margin requirements would discourage overcommitments and lend added financial stability to all market participants.

Margin requirements would have precluded many of the overcommitment problems, discussed above, in forward trading of government related mortgage-backed securities. The vast majority of the serious over-commitments in this area have apparently resulted from the ability of investors to speculate without any initial cost, and to suffer increasing losses without having to make proportionate deposits.

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26/ These circumstances include non-compliance with applicable requirements under the 1934 Act, SEC rules, or rules of any SRO with respect to financial responsibility or hypothecation of customers securities. See Section 5(a)(2), Securities Investor Protection Act of 1970, 15 U.S.C. 78aaa5(a)(2).

Recognizing the probable efficacy of margin requirements in forward transactions respecting mortgage-backed securities, several major dealers have already begun voluntarily to demand margin payments from most customers entering into forward commitments with them. In addition, GNMA, PSA Self-Regulation, Inc., and the MBS Clearing Corporation have all implemented or proposed margin-related requirements and guidelines for forward trading. Likewise, there was near unanimity among the industry representatives, regulators, investors, and other persons interviewed that at least some form of maintenance margin requirements should be applied to forward trading in government related mortgage-backed securities. 27/ In this regard, however, several persons expressed the view that margin requirements should not be applied to mortgage bankers in the normal issuance process for GNMAs.

A number of technical questions will confront any attempt to impose margin requirements with respect to government related securities. These include (1) whether dealers should be required to post, as well as to demand, such payments with respect to their forward commitments; (2) whether exemptions should be recognized for commitments that are hedged in some manner; (3) if so, what sort of hedging should qualify, and what types of market participants should be able to take advantage of such exemptions; (4) in what forms will margin be allowed to be posted--cash, pledged securities, or letters of credit; (5) what entities should hold the margin payments for various classes of transactions; and (6) whether a clearing facility should be established to facilitate compliance with margin requirements. 28/ The successful application of mandatory margin requirements in other segments of the securities

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27/ See, e.g., Rule 431(c)(2), NYSE Guide (CCH) ¶ 2431.

28/ See discussion in chapter VI, *infra*.

markets suggests that these questions can be resolved satisfactorily. In addition, the stock exchanges impose maintenance margin requirements on their members with respect to purchases of exempted securities on credit.

In addition to margin requirements, net capital and segregation requirements have been suggested for dealers. By requiring a conservative financial structure and full coverage of firm liabilities by qualifying assets, the net capital rule attempts to guarantee that subject dealers will be able to satisfy their customer obligations at all times. And, there seems to be little doubt that the net capital rule is reasonably effective in promoting the financial soundness and responsibility of dealers in non-exempted securities. Nevertheless, trading in government related securities is different in certain respects from trading in corporate securities. 29/ Accordingly, careful consideration is needed to determine what requirements in the area of net capital would be appropriate for dealers in government related securities.

Several of the cases described in Appendix A involved misuse by government securities dealers of customer funds or securities--e.g., selling or hypothecating customer securities or using customer funds in the dealer's operations. As applied to trading in non-exempted securities, requirements exist that seem to be reasonably effective in protecting customer-owned assets. Reserve and segregation requirements could be devised that would provide increased protection for customer-owned assets held by government related securities dealers. In one of the cases described in Appendix A, such requirements were applied with respect to customers' government

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29/ For example, the characteristics of government securities trading may make it possible for dealers to hedge their commitments effectively in ways that are not effective or reliable for other types of securities.

related securities accounts and played a substantial role in preventing customer losses despite the dealer's insolvency. (See case 7.)

It may also be appropriate to require non-bank government securities dealers to join SIPC. Such a requirement would protect smaller investors from losses occasioned by dealer insolvencies 30/ and help to preclude any loss of public confidence in the government related securities markets. The costs of SIPC membership represent a sharing by securities dealers of the risk of investor injury, and are now relatively small. 31/

Standards of Fair Practice

Many investors deal with securities dealers from a position of unequal knowledge and understanding of relevant investment information. To protect investors from overreaching and unfair practices by dealers, the SEC and the SROs have prescribed several categories of "fair practice" rules, which generally require dealers to treat investors in accordance with "just and equitable principles of trade." 32/

Confirmations and disclosure. Several "fair practice" rules require dealers to disclose to investors information important to an understanding of their

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30/ It is important to note, however, that SIPC ensures only $100,000 in securities claims, including up to $40,000 in cash per customer at a member firm. Government related securities transactions frequently involve amounts much greater than this. SIPC is supporting the introduction of legislation which would raise the amount of coverage to $500,000, including up to $100,000 in cash. S. 1076, 96th Cong., 2d Sess. (1980).

31/ Each SIPC member was required to pay an assessment equal to one-eighth of one percent of its gross securities revenues at the time the SIPC fund was established. The SIPC fund currently approximates $190,000,000 and is supported by assessments on members not to exceed $150 per annum.

32/ See, e.g., Rules of Fair Practice, Article III, Section 1, NASD Manual (CCH) ¶ 2151.

securities transactions. For example, SEC and SRO rules require confirmations of transactions, including those in exempted securities, to be sent to customers on or before settlement of a transaction disclosing, among other things, the price and identity of the securities bought or sold, the dealer's capacity (principal or agent) in the transaction, and the commissions charged by the dealer when acting in an agency capacity. 33/ Such requirements protect investors by providing them with disclosure of the terms on which their money and securities are being handled and the charges they are incurring. They also protect both dealers and investors by minimizing the chances of repeated unauthorized trades and creating a record the parties can refer to in case of subsequent disagreements. Other SEC and SRO rules serving similar investor protection purposes require dealers to disclose interest rates in credit arrangements; 34/ and to disseminate to customers audited balance sheets reflecting the dealer's financial condition 35/ and account statements showing a customer's security and money positions. 36/

Suitability. Suitability rules seek to protect both the customer and the dealer by discouraging customer transactions that are inappropriate in view of the

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33/ See Rule 10b-10, 17 CFR 240.10b-10; Rules of Fair Practice, Art. III, Sec. 12 NASD Manual (CCH) ¶ 2162; Rule 9.11, CBOE Guide (CCH) ¶ 2311. See Rule G-15, MSRB Manual (CCH) ¶ 3571, for more detailed confirmation requirements.

34/ See Rule 10b-16, 17 CFR 240.10b-16. Bank dealers which extend credit are subject to the disclosure provisions of the Truth-in-Lending Act, 15 U.S.C. 1601 et seq.

35/ See Rule 17a-5, 17 CFR 240.17a-5; Rule 9.13, CBOE Guide (CCH) ¶2313. Bank dealers are subject to the reporting requirements of the federal bank regulatory agencies.

36/ See Rule 9.12, CBOE Guide (CCH) ¶ 2312.

customer's financial situation and investment objectives. Such rules typically prohibit dealers from recommending, and in some cases executing, 37/ securities transactions unless the dealer reasonably believes that the transaction is suitable for the customer in light of a customer's financial resources, investment objectives and needs. One SRO rule requires the subject dealers to make suitability determinations upon the basis of relevant information, if any, proffered by a customer. 38/ Stricter rules impose an affirmative duty on dealers to inquire into the investment objectives and financial situation of customers before making a suitability determination. 39/ Perhaps the most stringent SRO suitability rule forbids subject dealers from recommending a transaction unless they reasonably believe that the customer, in addition to being financially suited to the transaction, has sufficient knowledge and experience in financial matters to evaluate the risks of the transaction. 40/

Closely allied to suitability rules are "know your customer" rules, which affirmatively require dealers to inquire about facts such as a customer's occupation, investment objectives, and financial situation, i.e., information relevant to a suitability determination. 41/ In addition to serving as a fundamental

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37/ See Rule 15c2-5, 17 CFR 240.15c2-5.

38/ See Rules of Fair Practice, Art. III, Sec. 2, NASD Manual (CCH) ¶ 2152.

39/ See Rule 15b10-3, 17 CFR 240.15b10-3; Rule 15c2-5, 17 CFR 240.15c2-5; Rule 9.9, CBOE Guide (CCH) ¶ 2309; Rule G-19, MSRB Manual (CCH) ¶ 3591.

40/ See Rule 9.9, CBOE Guide ¶ 2309.

41/ See Rule 15b10-6, 17 CFR 240.15b10-6; Rule 9.7(b), CBOE Guide (CCH) ¶ 2307; Rule 405, 2 NYSE Guide (CCH) ¶ 2405. Bank dealers are subject to the suitability rules of the MSRB, which include similiar provisions.

protection for customers who rely on the judgment and expertise of dealers, "know your customer" rules provide protection to dealers who might otherwise execute transactions for customers financially unable to fulfill their contractual obligations.

Fair pricing. To ensure that customers are not charged excessive prices or brokerage commissions, SROs have prescribed rules that require dealers, when acting as principals, to buy from or sell to customers at fair prices; and when acting as agents, to charge customers fair commissions. 42/ Fair prices and commissions are determined by factors such as market conditions at the time of the transaction, the total amount of the transaction, expenses involved in effecting or executing the transaction, the value of the services rendered, and the dealer's best judgment of the fair market value of the traded securities at the time of the transaction.

Trading authorization and churning. Another important objective of the fair practice rules is to ensure that dealers do not execute trades for customer accounts outside the scope of the authority given by the customer. Accordingly, SRO rules (1) prohibit dealers from exercising any discretionary trading power in a customer's account without prior written authorization from the customer, 43/ (2) require that supervisory persons approve in writing discretionary account transactions, 44/ (3) mandate frequent review of discretionary accounts to prevent irregularities and abuses, 45/ and (4) require the recording of all purchase and

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42/ See Rules of Fair Practice, Art. III, Sec. 4, NASD Manual (CCH) ¶ 2154; Rule G-30, MSRB Manual (CCH) ¶ 3646.

43/ Rules of Fair Practice, Art. III, Sec. 15, NASD Manual (CCH) ¶2165; Rule G-26, MSRB Manual (CCH) ¶ 3626; Rule 9.10(a), CBOE Guide (CCH) ¶ 2310.

44/ See Rule G-26(c), MSRB Manual (CCH) ¶ 3676.

45/ Id.

sale orders, regardless of execution. 46/ In addition, SEC and SRO rules expressly prohibit dealers from churning customer accounts, i.e., from causing trading activity that is excessive in size or frequency in view of the financial resources and character of a customer's account. 47/

Application to government related securities. Next to rules on financial responsibility, rules of fair practice could well be the most important to reduce the incidence of abuses in the market for government related securities. Although much of the trading volume in this market still consists of transactions between large sophisticated institutions, small less sophisticated investors are now participating in the forward markets for mortgage-backed securities. These investors stand at a significant informational disadvantage relative to securities professionals and are in the greatest need of effective "fair practice" protections.

If effectively enforced in government related securities trading, "fair practice" rules like those applicable to non-exempted securities probably could have deterred or reduced the incidence of many of the trading abuses discussed in Appendix A. Of course it is impossible to eliminate, by rule, every possibility of abuse. But a number of these rules proscribe, in relatively specific terms, the precise abuses that have arisen in a number of cases. Consistent with this view, industry representatives seem to favor extension of "fair practice" precepts to the government related markets. The leading association of dealers in mortgage-

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46/ See Rule 15c1-7, 17 CFR 240.15c1-7; Rules of Fair Practice, Art. III, Sec. 15, NASD Manual (CCH) ¶ 2165; Rule G-19(b), MSRB Manual (CCH) ¶ 3591; Rule 9.10(c) CBOE Guide (CCH) ¶ 2310.

47/ See Rule 17a-3, 17 CFR 240.17a-3 Rules of Fair Practice, Art. III, Sec. 21, NASD Manual (CCH) ¶ 2171; Rule G-8, MSRB Manual (CCH) ¶ 3536.

backed securities has approved certain "fair practice" rules for trading by its members. In addition, a number of government securities dealers, including several of the largest dealers which deal with many of the most sophisticated institutional customers, have already implemented, on a voluntary basis, guidelines, mechanisms, or procedures that resemble some of the principal "fair practice" rules.

Suitability rules, in particular, would address an important problem area in the trading of government related securities. There are a number of instances when small institutions and individuals have engaged in unsuitable transactions in government related securities. Any kind of significant suitability and know your customer requirements, especially if implemented with procedures such as credit checks, would have prevented some of these problems. Moreover, the great majority of industry representatives we spoke with, as well as most of the governmental agencies, believe that appropriate suitability rules can be formulated and should be applied to trading in government related mortgage-backed securities. The leading association of mortgage-backed securities dealers has proposed specific suitability requirements, and several dealers in such securities have implemented suitability requirements on their own initiative. 48/

Standards of Competency and Integrity and Supervision Requirements

Competency and qualifications. To ensure that investors are served by competent and honest securities professionals, SEC and SRO rules prescribe minimum competency requirements for securities dealers. These rules require certain

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48/ We note, however, that formulation and application of suitability rules with respect to institutional investors, which constitute a large percentage of the purchasers of government related securities, can raise issues not generally encountered with respect to suitability rules respecting individual investors.

employees of dealers to pass minimum competency examinations before being deemed qualified for employment. 49/ In addition, some SROs require the principals of dealer firms to pass a specific examination to assure that they are sufficiently competent to handle supervisory responsibilities, 50/ and require securities salesmen to complete training courses 51/ and apprenticeships 52/ before transacting business with the public.

Integrity and disqualification. To promote integrity among securities dealers, SEC and SRO rules prescribe disqualification procedures for dealers and their associated persons who have been expelled or suspended from SRO membership, have willfully violated any provisions of the securities laws, or have committed other enumerated infractions. 53/ Hiring and termination procedures prescribed for registered dealers are designed to identify dishonest salesmen by requiring hiring firms to make inquiries into the previous employment records and reputations of prospective employees 54/ and to file notices with SROs when salespersons leave, specifying the reasons for departure and disclosing whether the salespersons were the subject of any major complaints. 55/

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49/ See Rule 15b8-1, 17 CFR 240.15b8-1; Rule G-3, MSRB Manual (CCH) ¶ 3511; Rule 9.3, CBOE Guide (CCH) ¶ 2303. Rule 345.15, 2 NYSE Guide (CCH) ¶ 2345.

50/ See Rule G-3(d), MSRB Manual (CCH) ¶ 3511; Schedule C, Details of Qualification Examination, NASD Manual ¶ 1102A.

51/ See Rule 9.3, CBOE Guide (CCH) ¶ 2302; Rule 345.15, 2 NYSE Guide (CCH) ¶ 2345.

52/ See Rule G-3(h), MSRB Manual (CCH) ¶ 3511.

53/ See Sections 3(a)(39), 15(b)(4), 15(b)(6), 15B(a)(2), 15B(c)(2) of the 1934 Act; Rule 15b8-2, 17 CFR 240.15b8-2; Rule 345(d), 2 NYSE Guide (CCH) ¶ 2345; Rule G-4, MSRB Manual (CCH) ¶ 3516.

54/ See Rule 345.18, 2 NYSE Guide (CCH) ¶ 2345; Rules of Fair Practice Art. III, Sec. 27, NASD Manual (CCH) ¶2177.

55/ See Rule 345.13, 2 NYSE Guide (CCH) ¶ 2345; Rule 9.3, CBOE Guide (CCH) ¶ 2303.

Supervision. Strict supervisory rules have also been prescribed to assure that sales personnel and other associated persons of dealers perform their duties without violating the securities laws or SRO standards of conduct. These rules typically require dealers (a) to appoint firm officials to supervise the securities activities of all persons associated with the firm; (b) to establish, maintain, and enforce written procedures to assure compliance with broker-dealer supervisory responsibilities; and (c) to designate a firm official to review supervisory activities of supervisors and inspect each business office of the dealer to ensure that the written procedures are enforced. 56/

Application to government related securities. As indicated above, there have been several notable examples of incompetence and dishonesty on the part of certain dealers in government related securities, and equally notable examples of inadequate training and supervision of salesmen by such firms. Implementation of meaningful standards of training, qualification, and supervision would discourage situations in which major departures from reasonable standards are widespread within a firm and are continuing in nature. In addition, state securities regulators and other persons familiar with past abuses in municipal securities trading have emphasized that a number of past violators in the now-regulated municipal securities area are currently active in government related securities. Accordingly, employee

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56/ See Rule 15b10-4, 17 CFR 240.15b10-4; Rules of Fair Practice, Art. III, Sec. 27, NASD Manual (CCH) ¶ 2177; Rule G-27, MSRB Guide (CCH) ¶ 3631; See Rules 342 and 405, 2 NYSE Guide (CCH) ¶¶ 2342, 2405, and Rule 9.8 CBOE Guide (CCH) ¶ 2308, for much briefer supervisory rules.

reviews, background checks, and other mechanisms to identify persons previously disqualified from associating with dealers would be helpful in improving the integrity of the trading markets in government related securities.

Of course, the majority of government securities dealers now appear to be observing reasonable standards of competence, training, and supervision on a voluntary basis. Likewise, the leading association of mortgage-backed securities dealers has proposed rules which are designed to improve training and supervision requirements for its members. 57/ Because of its concern with abuses in the markets for mortgage-backed securities, GNMA supports the imposition of competency, integrity, and supervision standards; and so do the regulatory authorities interviewed for this study. Nevertheless, no formal rules in this area legally bind firms dealing exclusively in government related securities, and the presence of even a relatively small group of less capable and less scrupulous firms and salesmen in the industry poses a potential threat to less sophisticated individual and small institutional investors.

## Dealer Registration

Securities dealers may not engage in an interstate business in nonexempted securities or be members of SROs without complying with the SEC's registration requirements. 58/ Initially, these requirements serve to implement the qualification requirements and serve an important identification function since, prior to registration

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57/ See Chapter V, *infra*.

58/ See Section 15(a)(1), and Section 15B(a)(1) of the 1934 Act. See also Sections 6(c)(1), and 15A(g)(1) of the 1934 Act.

with the SEC or joining an SRO, a dealer must file an application disclosing specific information, 59/ and must meet prescribed standards of competence, operational capability and financial responsibility. 60/ Thereafter, the registration requirements allow the SEC and SROs to monitor broker-dealer compliance with the applicable regulatory requirements, including the bookkeeping and record-keeping provisions, 61/ the rules calling for the filing of periodic financial reports, 62/ and the financial responsibility rules. Registration requirements also play an important role in connection with the SEC's statutory disqualification authority and rules, which provide for the denial or revocation of a dealer's registration for failure to comply with SEC or SRO rules and standards. 63/

Application to government related securities. Mandatory government securities dealer registration is an essential condition for assuring compliance with most of the regulatory measures that might be applied to trading of government related securities. Without mandatory registration, regulatory authorities would encounter great difficulties in keeping track of dealers and in developing systems to monitor and ensure compliance. A number of the industry experts interviewed in

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59/ See Rule 15b1-1, 17 CFR 240.15b1-1; Rule 345.11, 2 NYSE Guide (CCH) ¶ 2345; Rule 9.3, CBOE Guide (CCH) ¶ 2302. See also Rule 15Ba2-1, 17 CFR 240.15Ba2-1 (bank dealer registration).

60/ Rule 15b8-1, 17 CFR 240.15b8-1; Rule G-3, MSRB Guide (CCH) ¶ 3511.

61/ See note 69 & accompanying text infra.

62/ See notes 70-71 & accompanying text infra.

63/ See Sections 15(b)(1), 15(b)(4), and 15B(a)((2) and (c)(2) of the 1934 Act; cf. Sections 3(a)(39), 6(1)93)A, 15A(g)(3)(a), and 19(h) of the Act; Rule 15b8-2, 17 CFR 240.15b8-2; Rule 345, 2 NYSE Guide (CCH) ¶ 2345.

connection with this study expressly indicated the desirability of universal registration requirements for dealers in government related mortgage-backed securities. In addition, absent such requirements, new means would have to be developed to implement standards of competence and integrity and to impose disciplinary sanctions if these measures were imposed on dealers in these securities. There is no assurance that such new means would be as efficient or effective as the systems based on mandatory registration.

## Books and Records

SEC and SRO rules require registered dealers to maintain accurate books and records on, among other things, all purchases and sales of securities; copies of confirmations of all purchases and sales; all assets and liabilities of a firm; cash and margin accounts of customers; securities in transfer; dividends and interest received; securities and money borrowed and loaned; securities not received or delivered; long and short positions in securities; brokerage orders and instructions for purchases and sales (regardless of execution); repurchase agreements; employment questionaires for associated individuals; and customer complaints. 64/ Related rules and statutory provisions also require dealers to designate a firm official to assure maintenance and preservation of records, 65/ and provide for the right of inspection by an SRO or the SEC at any reasonable time. 66/

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64/ See Rule 17a-3, 17 CFR 240.17a-3 Rules of Fair Practice, Art. III, Sec. 21, NASD Manual (CCH) ¶ 2171; Rule G-8, MSRB Manual (CCH) ¶ 3536.

65/ See Rule G-10, MSRB Manual (CCH) ¶ 3546.

66/ See Section 17(a) of the 1934 Act; Rule G-9, MSRB Manual (CCH) ¶ 3541. Inspection of bank dealers is done by the federal bank regulatory authorities.

Application to government related securities. As indicated above, serious deficiencies in recordkeeping practices have been evident in some of the recent cases described, and these deficiencies made it difficult for the firms to assess accurately their own capital positions or to guide their business operations. Appropriate recordkeeping would obviously have prevented problems due to these deficiencies. Moreover, enforcement of most of the regulatory measures discussed above (e.g., margin, net capital) would require the maintenance of at least some standardized types of records.

## Reporting, Compliance, and Enforcement

A variety of mechanisms have been developed to achieve a high level of compliance with the regulatory measures applicable to registered securities dealers.

Reporting and early warning systems. To find violations of financial responsibility and other related rules at an early stage, the SEC has developed a reporting and early warning system based largely on mandatory reporting by dealers. The reporting and early warning system ensures that current information on each dealer is available to the SEC and provides a mechanism for SEC action in the event a dealer fails to conform to the rules.

Dealers that carry customer accounts are required to prepare reports monthly, quarterly, and annually and to file them with the SEC. 67/ The annual reports must be certified by an independent public accountant and must be furnished to all customers. 68/ In addition, when a dealer fails to comply with the SEC's

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67/ Rule 17a-5(a), 17 CFR 240.17a-5(a). Bank dealers are not subject to these reporting requirements.

68/ Rule 17a-5(c), 17 CFR 240.17a-5(c).

reserve and segregation requirements or net capital rule or fails to keep its books and records current according to the SEC's recordkeeping rule, the dealer must provide immediate notice to the SEC, and must file special reports with the SEC for a specified period of time, 69/ until it demonstrates its ability to comply with applicable rules.

Compliance: Inspections, disciplinary proceedings, oversight, and enforcement. Aside from the reporting and early warning systems, the task of ensuring compliance with the rules applicable to registered brokers and dealers is performed by a two-tiered system in which (1) the SROs are delegated governmental-type powers and responsibilities to enforce compliance by their respective members, and (2) the SEC performs both an oversight role to ensure that the SROs carry out their responsibilities effectively and fairly, and a supplemental enforcement role.

SROs seek to enforce compliance with the federal securities laws and their own rules primarily through inspections and disciplinary proceedings. SRO rules and procedures provide for inspection of all members within certain time periods. 70/ A system of market surveillance operated by the SROs supplements these inspections. Disciplinary sanctions are imposed on members or persons associated with members by SROs for violations of the 1934 Act or SEC or SRO rules. 71/

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69/ Rule 17a-11, 17 CFR 17a-11. The rule also requires a self-regulatory organization to give immediate notice to the SEC in the event it discovers a violation of any of the rules by a member.

70/ See, e.g., MSRB Rule G-16 (requires inspection of municipal securities brokers and municipal securities dealers once every two years).

71/ An SROs sanctions may include, for example, censure, suspension of up to five years, expulsion, or fines of up to $25,000 for a member or $100,000 for a member firm.

The SEC, in its oversight role, reviews the performance of the SROs through oversight inspections of member firms and of the SROs themselves. The SEC itself also inspects firms registered with the SEC that are not members of an SRO. Under the 1934 Act, inspection and compliance authority for bank dealers is allocated to the federal bank regulatory agencies. The SEC also has the authority to inspect these entities, after notice and consultation with the appropriate regulatory agency. Finally, the SEC has administrative enforcement authority over all persons registered with it 72/ and may institute injunctive actions in the federal courts to enforce compliance with the securities laws by persons not so registered.

Application to government related securities. A number of the cases described in Appendix A involved widespread and continuing abuses that may have been caught by inspections or possibly prevented if the entities had been subject to a regulatory program and had been inspected, although some abuses would no doubt persist under any possible compliance system. Reporting and early warning are particularly efficient mechanisms for monitoring and encouraging compliance with those financial and operating requirements that, in themselves, require regulated firms to perform analyses and tabulations of internal information. Audit requirements help assure that books, records, and reports are accurate. Inspections not only provide further assurance of such accuracy but also furnish a principal method of encouraging and monitoring compliance with a broad range of substantive requirements.

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72/ This includes broker-dealers, municipal securities dealers, registered securities information processors, and SROs.

The existing reporting, compliance, and enforcement system for registered dealers seems to be reasonably effective. Its flexibility, moreover, has recently been demonstrated by the application of this system to the municipal securities markets. Absent some measures analogous to those employed in this existing system, there would seem to be no assurance that any substantive regulatory requirements that might be imposed on the trading of government related securities would actually be followed.

# APPENDIX

## SEC INVESTIGATIONS OF CASES OF ABUSIVE TRADING PRACTICES

The following factual accounts, based upon the results of actual lawsuits, investigations, and inquiries, present examples of problems and abuses in the trading of government and government related securities. Although we believe that the accounts accurately present the major facets of the respective cases, particular facts in some of the cases may be subject to dispute. The names of parties and other identifying characteristics in the cases have been omitted to prevent the disclosure of nonpublic or sensitive information.

Case # 1

In this early administrative proceeding, unsuitable transactions were entered into by a large registered broker-dealer for the account of a major public university. The broker-dealer also churned the account and failed to reflect the account's transactions properly on its books and records.

The subject transactions involved government securities, including forward commitments executed in 1974 to purchase GNMAs. The university had sought low risk investments for its investment account of approximately $1.5 million. Nevertheless, its account acquired commitments exceeding $3 million, and sustained losses of nearly $1 million.

These unsuitable trades had been handled by only one of the broker-dealer's registered representatives. The SEC brought an administrative proceeding against the broker-dealer and accepted a settlement which included findings of a failure to supervise the registered representative involved. In addition, the broker-dealer agreed to take remedial steps to prevent recurrence of these activities, including written approval of manager prior to execution of GNMA forward commitments in excess of specified amount and the institution of procedures for the early detection of excessive trading activity by account executives. The registered broker-dealer reached a settlement with the university in which it agreed to share the losses that had been sustained and pay approximately $400,000 to the university, resulting in a net loss to the university of approximately $600,000.

Case #2

B Corporation was an unregistered dealer in government-issued and government guaranteed securities with offices in the Midwest and in New York City. B engaged in repurchase agreements and reverse repurchase agreements with respect to these securities with various entities, including corporations, banks, and state and local governments. B filed a voluntary petition of bankruptcy in late-1975.

B accumulated a portfolio of well over a billion dollars worth of securities, primarily Treasury securities, by buying the securities and immediately putting them out on repurchase agreements during a period when repo rates were lower than the rates on government securities. As long as the rate of return on the securities exceeded B's cost of financing the purchase of the securities, B profited on the arbitrage between the two rates, and used these profits

to build an extensive pyramid of government securities. When interest rates unexpectedly rose, however, causing the cost of borrowing to rise and the market price of B's government securities inventory to drop, B experienced severe financial problems. During a two-week period in mid-1975, B defaulted on several repurchase agreements. Although B was insolvent during this period, it continued to operate, and entered into at least one additional repurchase agreement.

B's financial problems were exacerbated by its failure to maintain complete and accurate books and records. Its recordkeeping relied in large part on uncorrelated purchase and sales confirmations, some of which were maintained in chronological order while others were ordered according to other systems. Accordingly, these confirmations provided no useful system for checking daily transactions. Further, B's logs of transactions failed to reflect accurately all of its securities transactions, and, for its final year of operations, B failed to maintain various journals and ledgers.

Although B did large amounts of business with its major customers, it failed on several occasions to honor their requests for its financial statements. These financials would have revealed the company's precarious position. Moreover, when B turned its books and records over to a bankruptcy receiver, these documents were so incomplete and disorganized that the receiver had to engage an accounting firm to attempt to determine B's position with regard to its open repurchase and reverse repurchase agreements. The books were in such bad condition, however, that the accountant was unable to express an opinion on the company's financial condition for any period during 1975.

Papers filed in the bankruptcy proceedings indicate that B's liabilities exceeded its assets by $19 million. While the total amount of losses resulting from B's defaults is not known, two repo customers reported losses totalling $2.4 - 2.8 million.

Case # 3

G was incorporated in 1973 and shortly thereafter began doing business as an unregistered broker-dealer in government and municipal securities. G ceased its municipal securities business in 1975 when the Securities Acts Amendments of 1975 became effective, thereby requiring registration with the SEC of municipal securities broker-dealers. From 1975 through 1977, G engaged in the purchase and sale of securities issued by the U.S. Treasury, and sponsored federal agencies, and mortgage-backed securities guaranteed by GNMA.

In early 1976, G began selling GNMA certificates and Treasury securities under agreements to repurchase. Over the course of the next eighteen months, G solicited and entered into 27 separate fraudulent repo transactions, generally with small banks and savings and loan associations. It solicited customers by representing that it was acting as agent for a bank, and would pay interest generally 1% higher than the prevailing federal funds rate. Customers were assured that the investment was sound because it was guaranteed by the federal government.

G instructed customers to wire funds to several banks at which G had accounts. No securities were ever delivered to customers; rather, customers were told that they would be sent safekeeping receipts indicating that the securities purchased were deposited in third party banks. No such receipts were ever received by customers. In fact, G's own records indicate that it never owned or acquired the securities covered by the repo transactions.

Generally, when repo transactions fell due, G would engage in various practices to delay as long as possible the repurchasing of the securities. For example, it would: (1) issue confirmations extending the repo date without authorization, (2) claim that a foul-up in the wire transfer procedure had delayed repayment, or (3) write checks it knew would be returned for insufficient funds.

These practices resulted in G's failure to meet repurchase obligations totalling over $1 million.

Case #4

H, an unregistered broker-dealer involved exclusively in trading government-guaranteed and government-issued securities from its inception in 1974 until mid-1977 when it ceased doing business, was a wholly owned subsidiary of a registered broker-dealer that went out of business as a result of net capital problems attributable to the unregistered dealer.

More than 60% of H's business involved forward transactions in GNMA mortgage-backed securities with national and state banks, credit unions, and savings and loan associations. The balance of its business was in other government securities. H employed approximately 30 salesmen who were given territorial areas throughout the country in which to solicit institutional customers over the telephone.

H had tremendous success in late 1976 when GNMA prices were steadily rising, carrying approximately 250 accounts and often trading over $50 million a day. The firm's profit for December, 1976, was $1.7 million, and during that single month 10 of the salesmen each earned net commissions of over $40,000.

In early 1977, however, GNMA prices turned downward. At that time H's customers were committed to purchase GNMA securities totalling more than $400 million from the firm, with settlement dates through the first half of 1977. When certain customers disclaimed these transactions, H had to sell their securities at a loss, leaving its customers still owing $8.1 million on their commitments and leaving H short approximately $4 million on its commitments to dealers. H instituted, or planned to institute, law suits against 31 institutional customers who had disclaimed transactions, but most of the customers disclaiming transactions alleged that H engaged in unauthorized transactions or had misrepresented or omitted material information concerning the risks attendant to GNMA forward trading. In addition, some customers indicated that the individuals with whom the salesmen had dealt lacked authority to bind the institutions. Four suits were also filed against H alleging violations of the securities laws and common law fraud.

In the following three months, representatives of the dealers to whom H owed money attempted to work out a plan to permit H to continue operating, under certain restrictions, in an effort to reduce the outstanding indebtedness. H, however, was unable to generate sufficient business to meet its overhead. It ceased doing business in mid-1977, leaving $4 million owing to its customers and dealers.

There appear to have been numerous causes of the aforementioned problems, including principally agressive sales practices which led to customers becoming over-committed in connection with GNMA forward transactions, and then refusing to take delivery when interest rates rose. H failed to train its salesmen or to exercise any meaningful supervision or control over them. Of the salesmen employed by H, at least 15 had either no experience in the sale of government securities or experience limited to municipal securities. Despite this lack of of experience, H established no rules or guidelines concerning suitability, trade authorization, or the mark-ups, mark-downs, or spreads charged on transactions. Salesmen were permitted to engage in transactions of any size without authorization from principals. While one of the principals conducted a "training program," it laid little stress on trading procedures and regulation, but emphasized (1) that customers were not required to commit any capital at the time they purchased GNMA commitments and (2) that the firm was therefore justified in reducing customer profits and keeping as much profit as possible for itself. Supervisors also impressed upon salesmen that they could earn commissions only only by causing active trading in their customers' accounts. The relatively high 40% commission rate obviously contributed to the salesmen's incentives to engage in excessive trading.

As a general practice, the salesmen used high-pressure, "boiler-room" sales techniques in soliciting customers, and misstated and omitted to state

many material facts in connection with these solicitations. Using aggressive and persistent presentations in telephone contacts with banks, savings & loans, and credit unions, the salesmen emphasized that quick profits could be made in trading GNMAs and that such profits could be made without risk and without committing funds, because no margin was required. In some cases they told customers that delivery would not have to be taken because the securities could be sold at a profit prior to delivery. Customers were also told that, in the event delivery had to be taken, H would arrange reverse repurchase agreements as a means of extending credit. In this manner, customers who could not afford to accept delivery of GNMA securities were induced to trade in such contracts without being informed of the risks inherent in reverse repo agreements. Indicative of the resulting over-commitments, one credit union with total assets of under $1 million was committed to purchase $5 million worth of securities, and a bank with $11 million in total assets was committed to purchase $21 million in securities.

Once a customer had purchased commitments for GNMA's, the salesman would seek authorization to commence trading on a discretionary basis for the customer's account. Even where authorization was not received, salesmen nevertheless sometimes bought and sold GNMA securities for the customer's account and then, in an effort to obtain such authorization, sent confirmations, or "wooden tickets," notifying the customer of its profit.

In the rising market that existed during the final quarter of 1976, the salesmen engaged in trading practices that enabled them and the firm to reap enormous profits while reducing customers' profits. The fact that the customers were continuously realizing profits apparently prevented them from discovering these unconscionable practices. For example, notwithstanding the rising market, the salesmen frequently repurchased customer commitments as soon as there was a small profit in an account, e.g., 1/32 or 2/32 of a point, and then had the firm resell the commitment to another customer. Some of these repurchases were effected without authorization, while in other cases the firm had apparently convinced the customers to give it trading discretion. The salesmen generated enormous profits by engaging in excessive mark-up and mark-down practices in connection with these riskless principal transactions. For instance, a salesman would obtain the price at which H could sell a security to a third party and then determine the price it would pay its customer for the security, often making the purchase at a price substantially below the market.

Finally, the salesmen in some cases allowed, or even encouraged, the opening of "sham" accounts, where individuals acting under the guise of an institution or corporation traded GNMA securities for their own accounts. For example, one salesman persuaded two individuals with limited means to form corporations to trade GNMAs. These individuals traded over $185 million of GNMA securities, resulting in substantial losses.

Case # 5

"I" was formerly an office manager for a large registered broker-dealer. J and K were registered representatives in the same office. I, J and K also owned one corporation and one partnership that traded in government securities.

Using information obtained from the broker-dealer, I, J, and K schemed to interposition their corporation between the registered broker-dealer and outside broker-dealers to make profits in government securities trades. They concealed this from the broker-dealer by the use of the government bond trading department of a large national bank. Beginning in late 1973, J arranged for the corporation to open a bank account and bond trading account at the national bank. All contacts with the bank were made through one of its vice presidents, who worked in its government bond trading department. This vice president was a long-time friend of J. For 2 1/2 years thereafter, numerous trades of government bonds were carried out among the broker-dealer, the interpositioned corporation, the bank's bond department, and outside parties.

J, who did most of the government securities business in the broker-dealer's office, determined each morning at what prices the broker-dealer's government bond traders in New York would sell certain bonds and related this information to I, K and the bank's vice-president. With this information and the aid of the bank's vice president, purchase prices were obtained from outside dealers. The bank's vice president, with I, J, and K, would then cause the bank to place orders through the broker-dealer to buy bonds at prices at which the broker-dealer was willing to sell. Once the trade was made, the vice president would execute a sale to an interpositioned corporation at or near the purchase price from the broker-dealer. Simultaneously, the vice president would execute another trade with the corporation buying the government securities back at a higher price. He would then sell the bonds out to the outside dealers.

Thus, profits which, but for the interpositioning, would have gone to the broker-dealer or to outside purchasers were diverted through the bank's bond department to companies owned by I, J, and K. These three men also made commissions from the broker-dealer on the orders of bonds the bank placed through them. In a two and one-half year period, I, J, and K made over 180 interpositioned trades and over $268,000 in profits.

When the scheme was discovered in mid-1976, I and the vice president were fired. J and K also left the broker-dealer in mid-1976.

In 1977, the SEC instituted an administrative proceeding against I, J and K. In a subsequent settlement, I and J were barred from association with any broker or dealer, and K was suspended for three months from any association with any broker or dealer and received a further nine months suspension from any association other than in a supervised capacity. No administrative action could be taken against the bank vice president.

Case #6

N Corporation was a holding company which owned four banking subsidiaries and had a class of securities that were registered with the SEC pursuant to Section 12(g) of the Securities Exchange Act. Bank M, the largest of these subsidiaries, failed in October, 1975. Bank M accounted for most of the assets of N Corporation, and its failure led to the collapse of N as well.

In early 1973, in an effort to avoid recognizing an $805,000 loss suffered in connection with short sales of government securities, M engaged in "adjusted trading" of U.S. Treasury and government-guaranteed securities. Adjusted trading is the practice of pairing purchases and sales of securities at a price in excess of the current market price.

Three basic methods of adjusted trading were employed. First, the bank sold securities to a registered broker-dealer at prices from three to four points above the market and subject to oral repurchase agreements. The bank repurchased these securities at similarly inflated prices in the following month. The bank treated these transactions as outright sales and separate purchases of securities.

The bank's second method of adjusted trading was bond swaps, in which the bank would sell securities to a dealer at the current market price plus a one to four point premium and, later the same day, purchase different securities from the same dealer at the market price plus the same one to four point premium. Bank M engaged in these swaps with both a large national bank and a second registered broker-dealer. The national bank had established no staff guidelines on adjusted trading and allowed trades to take place at premiums of three to four points over the market. The registered broker-dealer also permitted adjusted trading, although supervisory personnel within the broker-dealer prohibited premiums of any more than about one point over market, which approximated a day's range of trading. As a result of these swaps, Bank M avoided showing losses of over $250,000.

Bank M's third method of adjusted trading involved the "sale" of $4 million of securities to an unregistered municipal securities dealer at prices more than three points above the market. This sale, executed through a separate broker acting as agent for the dealer, nominally occurred at the market, but Bank M then charged the dealer's account $124,000, which constituted the dealer's overpayment. In return, Bank M agreed to purchase about $8 million of municipal securities from the dealer at a price 1 1/2 points above the market, thereby reimbursing it for the $124,000 loss it had incurred. As a result of this transaction, Bank M avoided showing losses of over $100,000.

As a result of these adjusted trading practices, the published financials of Holding Company N understated its 1973 losses by about 19%. The trades also caused the overstatement of the value of Bank M's securities inventory by about $400,000.

Case # 7

O was a registered broker-dealer which had offices in two cities. O was a member of the NASD, and its primary business was trading in municipal and government securities.

O began trading GNMAs in 1978. In mid-1978, one of O's salesmen, without authorization, agreed to take a $4 million position in forward commitments to purchase GNMAs with a broker-dealer in New York. At that time, O had only nominal net capital. Interest rates moved up in the following two months and O sustained large losses which more than wiped out its capital.

O's difficulties in this period were compounded by problems it experienced in introducing a computerized recordkeeping system and by O's failure to maintain a manual backup system. These recordkeeping deficiencies were so serious that O was unable to compute its capital position at the time the large forward position was assumed.

It also appears that O engaged in unsuitable and fraudulent transactions in the account of one of its individual customers. This customer was a mechanic with limited formal education and a net worth of only a few thousand dollars. O promised to alert him whenever his losses exceeded $2,500. Nevertheless, one of O's salesmen used this customer's account to purchase millions of dollars worth of GNMA forwards, while assuring the customer that he would never have to take delivery on the certificates, and would only make money on changes in interest rates.

The SEC learned of O's net capital problems and its continuing operations while insolvent as a result of a routine NASD inspection. The SEC obtained injunctions against further violations against O, and its chairman and president. O was placed in receivership and administrative proceedings may also be instituted in connection with the same facts. None of O's customers sustained financial losses as a result of the firm's financial collapse, although other dealers lost more than $300,000 as a result of O's failure to honor its forward commitments. The favorable outcome for O's customers resulted in part from the prompt discovery of its poor financial condition by the NASD and the SEC and in part from O's observance of the reserve and segregation requirements under which customer funds were held in a separate bank account for their exclusive benefit.

Case # 8

P Government Securities, Inc. is an unregistered affiliate of Q, a large registered broker-dealer. P was organized in 1973 to deal exclusively in government securities and is, accordingly, exempt from registration with the SEC. Nevertheless, all of P's accounts outside of New York City are serviced by registered representatives of Q. P and Q have established specialized rules for determining which entity handles particular types of government securities transactions for their customers.

In late 1976, R, an account executive specializing in government securities employed by Q, opened and began servicing accounts at P for two medium-sized mid-western cities and a police and fire pension fund of one of the cities. The purpose of the new accounts was to engage in "arbitrage" transactions in United States Treasury securities. R's arbitrage strategy involved borrowing a Treasury Note through P and selling it on the market (the short position). Simultaneously, the proceeds from this sale were used to purchase another Treasury Note of the same denomination with a different maturity date and interest rate (the long position). The only funds that changed hands between P and the customer were wire transfers representing the differences in prices between the two notes.

The arbitrage position was established by selecting securities whose yield to maturity appeared to be out of line with their "normal" historical relationship. A security whose yield appeared to be low was sold short while a security with a current yield higher than its historical yield was purchased for the long position. R expected that the yield of the securities would return to their "normal" levels, and that the account could then profit by liquidating the arbitrage - i.e. selling the long position and buying in the short position. Securities with similar maturity dates were usually paired on opposite sides of the arbitrage, creating a partially hedged position. With this arrangement,

market factors that caused one security to increase in value would also have an off-setting effect on the other security, resulting in little over-all effect on the account.

On R's recommendation, the cities and the pension fund engaged in arbitrage trading throughout the first half of 1977. None of them had engaged in arbitrage before, however, and they were not fully aware of the risks involved in an arbitrage strategy. The primary risk is that the yield of the securities involved may not move back to their historical relationship. In this event, the customer may recognize a loss on closing out the position. R apparantly did not fully disclose this market risk to the cities. In addition, he failed to explain the borrowing charges assessed by P in connection with the arbitrage transactions.

At first, the transactions engaged by the cities and the fund were successful, and they recognized aggregate gains of nearly $170,000 in the first several months. Gradually, however, R began recommending transactions which resulted in larger and larger open positions and wider disparities between the maturity dates involved in the arbitrages. This strategy increased the possibility that a large loss could be realized if the market did not move as predicted. In addition, the transactions were not arbitrages in the same sense the earlier activities were because the partially hedged position which resulted from choosing securities with similar maturities was gone. R also failed to disclose the special risks inherent in this new strategy.

By mid-1977, the two small cities and the pension fund taken together had open positions of well over $300 million. 1/ Beginning about that time, the market for Treasury securities failed to move as predicted, and losses resulted in a number of the arbitrages. Since the three entities each had large arbitrage positions, even small market movements caused large paper losses. By June 30, 1977, the three had sustained paper losses of over $670,000.

The cities' fiscal years ended on June 30, 1977, and they wished to close their accounts to recognize any gains. To avoid having to close the accounts and report losses to the cities, R devised a scheme whereby Q wired funds to each of the cities and the cities wired back approximately equal amounts the next day. R also prepared and mailed ficticious confirmation slips from P showing closing and reopening of the cities' open positions in the arbitrages. The prices shown on the confirmations were not market prices, but prices that would show no gain or loss to the cities. In fact, no transactions had occurred and the accounts remained open. 2/ The actual losses were not discovered until August, 1977, during one of P's audits. By this time, further losses had occurred in the accounts.

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1/ Between January and September, 1977, R effected over 20 arbitrages for the accounts of each of the cities. He also earned $90,000 in commissions during this period.

2/ An investment manager for one of the cities knew it had a potential loss in its open positions and knew the June 30 "trades" were done away from the market. He approved the deal to give R time to remedy the sutuation.

As a result of R's arbitrage strategy, the accounts of the cities and the pension fund showed net losses of $1,300,000. Q assumed these losses. As a result of SEC enforcement proceedings against R and Q and judicial settlement of these proceedings, Q instituted new procedures to (1) prevent use of false confirmations, (2) require additional approvals for fund transfers to avoid occurences such as the June 30 sham transaction, (3) provide for disclosure of borrowing charges, (4) require approval of all arbitrage accounts, and (5) implement a periodic review procedure for P's accounts. R was barred from association with a broker or dealer for five years, and one of Q's supervisors agreed to undergo retraining.

Case #9

From 1976 until late 1977, the portfolio manager of a state university, who was charged with the responsibility of investing university funds in short-term highly liquid government securities, used the university's account to accrue financial benefits totaling approximately $1.3 million for himself and a group of friends and business associates through trading fees generated by transactions in government-guaranteed securities. Despite the university's conservative investment objectives, and without disclosure to the university, the portfolio manager engaged in a highly speculative, leveraged trading program. This program involved the trading of GNMAs on a forward basis as well as when-issued trading of sponsored agency securities. After becoming over-extended on these forward commitments the portfolio manager engaged in reverse repurchase agreements to fund delivery of the securities purchased. Through the use of reverse repos, the portfolio manager was able to "pyramid" the university's investments, i.e., borrow money against securities owned to purchase additional securities. This strategy resulted in university commitments exceeding $250 million at a time when its assets available for investment were only about $60 million. Published accounts have estimated losses to the university of about $17 million.

While the portfolio manager often dealt directly with New York government securities dealers, he placed many of these transactions through broker-dealers owned by friends and associates, or that employed friends and associates. The portfolio manager himself was a part-owner of one such broker-dealer. One of those broker-dealers was registered with the SEC, while two others were not. In each instance the university was the sole, or at least the primary, customer of the broker-dealer or the salesman. These broker-dealers charged the university excessive mark-ups and commissions, and failed to disclose that they were also being compensated, at market rates, by the other party to the trade.

The university has not honored some of its outstanding commitments, resulting in suits for damages totalling approximately $1 million by two broker-dealers. One of the broker-dealers involved in the scheme is currently in receivership.

Case # 10

R was organized in 1977, was registered with the SEC as a broker-dealer, and was a member of the NASD. It operated a municipal and government securities business. S was a wholly-owned subsidiary of R's parent and was organized as an unregistered broker-dealer in 1978. S was incorporated separately of R, which had been losing money, apparently so that the government securities business could be conducted with less government regulation, including operating outside the net capital rule.

The trading practices used by the two firms in the sale of government-guaranteed securities, primarily GNMAs and FHLMCs, were similar and were carried out by R until S commenced doing business and continued the practices. The trading room was operated as a "boiler room," and telephone calls were made to potential customers -- frequently small financial institutions such as credit unions, banks, and savings and loans -- using sources such as bank directories and savings and loan directories. "Cold calls" to various types of potential customers resulted in a substantial number of sales. Salesmen for the firms were paid a commission of 40% of the firm's profits on each sale once the trades were settled. Sales were made without regard to the suitability of the purchase for the customer; salesmen made no inquiry of a customer's liabilities or net worth or other investment commitments. In a number of instances, customers of R and S entered into forward commitments for GNMAs and FHLMCs well in excess of the assets they had available to purchase the securities when the commitments became due. For example, a credit union with a net worth of $2.5 million was committed to take delivery of $5.5 million of government guaranteed securities within a month's time and had $11 million of additional commitments coming due in the following four months.

To enable some customers to avoid recognition of some losses they had incurred in their transactions, R and S entered into adjusted trades with these customers, purchasing the securities from them several points above the market, and selling other forward commitments to the customers at prices

also several points above the market. Some salesmen testified that they thought such trades were permissible as long as the mark-ups did not exceed 5 points. To insure that the customers would honor these further commitments, the firms sometimes required "margin money" in amounts sufficient to cover R's losses on the adjusted trades. 3/

Existing customers of R were not informed when S was organized, even though many of their accounts were transferred to the new entity. Neither these customers nor new ones were told that S was not registered with the Commission, was not an NASD member, and was not insured by SIPC. The same salesmen continued to deal with the customers, the business was operated out of the same office, and, although separate books were kept reflecting the government and municipal business, the firms' salesmen were not even sure which entity paid them.

In part because of accounting requirements, S recognized substantial losses in its adjusted trading. Its accountant required it to "book" losses resulting from adjusted trading immediately, but would not allow it to recognize the gain from the forward commitment sold to the customer until settlement. As a result, by the end of 1978 it had a negative net worth of over $600,000. Despite this insolvency, it continued doing business.

Through much of 1978, R and S borrowed money from a southern city through a series of repurchase agreements covering government guaranteed securities. In late 1978, S, while insolvent, began using funds borrowed from the city in its operations without maintaining the securities as collateral. In a practice termed "bucketing," it sent false confirmations to the city purporting to show purchases of the collateralizing securities when in fact no such purchases were made. In late 1978 and early 1979, the amount of uncollateralized funds was approximately $1.4 million. During this period, the management of the firm changed, and the $1.4 million was thereafter returned to the city. Included in this money, however, was approximately $500,000 of margin money of a credit union.

The changed management also refused to allow any more adjusted trading, and attempted to remove all the losses it had accumulated on its balance sheet through the adjusted trading by instituting a system of "swaps", which effectively closed out certain open positions for customers. The customers agreed to such "swaps" because R's management had represented that the losses which had been encountered and were hidden through the adjusted trading would not have to be recognized by the customers. In fact, the losses were recognized at this time.

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3/ One customer, a credit union, deposited over $60,000 of margin money in May 1978. A second payment of $446,156.77 was made in November 1978. Between $450,000 and $500,000 of this money was never returned to the credit union.

One customer recognized a loss of $1.4 million and also lost about $500,000 in margin money which was not returned. Two other credit unions recognized losses of over $20,000 each.

A permanent injunction was entered against S in early 1979. Three of that firm's salesmen and its manager have been barred from the industry. Administrative proceedings are pending against R and certain other persons.

Case #11

Company U is a no-load, open-end management investment company registered with the SEC under the Investment Company Act of 1940. U's investment objective is to provide current income to shareholders primarily through purchasing securities which are obligations of or guaranteed by the U.S. Government. In 1977 and 1978, the majority of U's portfolio consisted of GNMA certificates and other government guaranteed loans.

Broker T has been a registered broker-dealer and investment advisor since 1973. T shares offices with U and advises U on its investments. In addition, T and U have had at least two common officer-directors, including a common president, and these two individuals were primarily responsible for the selection, purchase, and sale of U's portfolio investments, including GNMAs.

A Commission inspection of U under the Investment Company Act revealed that commencing in 1977, U traded GNMA forwards and standbys and entered into reverse repos. By December 31, 1977, U had over $42 million in GNMA commitment in its portfolio, while its total assets other than these commitments were only $46 million. In its prospectus and advertisements to its existing and potential investors, U extolled the safety of its investments, stressing that the U.S. Government guaranteed them all. It did not apprise these investors of the risks inherent in forward contracts, standbys, and reverse repos; namely, the speculation in interest rates and the possibility of having to purchase GNMAs at a loss or when the company might not have sufficient funds to cover the purchase. In addition, U's financial statements understated the amounts of GNMA commitments held.

U's massive GNMA commitments came to the attention of U's board of directors in early 1978. (Under the Investment Company Act, 40% of U's directors were required to be independent of the company and its advisor.) The Board instructed the common officers of T and U to cease issuing commitments for GNMA forwards, and the Board further required those officers to execute an

indemnification agreement to U for losses it may have on $20 million in commitments as a quid pro quo for continuance of T's advisory contract with U. Pursuant to the indemnification agreement, the common officers reimbursed U for $700,000 in commitments losses. An additional $90,000 loss remains unreimbursed. Subsequent SEC proceedings resulted in additional monetary and nonmonetary relief.

Case #12

W, an independent unregistered broker-dealer, was organized in late 1977. During 1979 it raised at least $6.5 million from investors by purporting to enter into "repurchase agreements" on guaranteed student loans ("GSL's"). Apparently, however, W did not have GSL's as collateral, and it defaulted upon $4,500,000 in payments on these "repurchase agreements," and issued over $1,000,000 worth of dishonored checks in connection with two of these agreements.

W engaged in these transactions with credit unions, S & L's, banks, insurance companies, and other institutional investors. It represented that the GSL's were to be held by third parties or by the broker-dealer for the purchasers. However, the broker-dealer, after receiving funds from the customer, failed to produce the securities, even when requested. At this time it is unknown whether any securities were ever produced for any customer.

W told investors to whom it purportedly sold GSL's, among other things, that these securities were safe investments and were guaranteed by the Office of Education of HEW. W also told investors that it was in sound financial condition and would be able to repurchase the securities.

State authorities as well as the SEC have taken action against the broker-dealer and its principals. A receiver was appointed in the SEC action, and the company is presently in bankruptcy proceedings. Several private lawsuits are also pending. Because no meaningful records have yet been located, it is unclear how many institutions or other investors suffered losses. The total amount of the losses is also unclear, although it apparently exceeds $4,500,000.

Case #13

X, an unregistered government securities dealer, was affiliated with a registered municipal securities broker-dealer. The two firms were controlled by one individual and shared offices, management, and sales staff, but maintained separate books and records. X is presently insolvent and has filed a petition for bankruptcy. As a result of X's past trading activities, small banks, credit unions, and over 40 individuals may ultimately suffer losses exceeding $8 million.

X's financial collapse and the resulting losses to its customers appear to have been the result of a Ponzi-like scheme furthered by misrepresentations and omissions of material facts concerning both the nature of the investment packages it was offering to the public and the firm's financial condition. Beginning in early 1978, X engaged in selling GNMA securities to customers on a stand-by basis. Stand-bys are essentially put options -- the dealer pays the customer a fee for agreeing to "stand by" to purchase a specified amount of securities at a certain yield if the dealer exercises his option to sell the securities. By mid-1977, X had paid stand-by fees totalling $7 million. In order to pay these fees, X obtained funds from other customers through the use of "stand-by with pair-off" transactions. Pursuant to these transactions, X would purport to sell GNMA securities to the customer for forward delivery and, at the same time, would execute a stand-by commitment to repurchase the securities at a higher price on the settlement date. X would require payment of a stand-by commitment fee from the customer on the trade date. Customers were promised a return of 11-13% on their investments. This return consisted of the difference between (a) the price at which the customer would resell the securities to X, and (b) the amount paid by the customer for the securities plus the firm's stand-by commitment fee.

X, however, did not tell investors they were entering into "standby with pair-off" transactions; rather it told investors that their funds were being invested in existing GNMA securities, and that these investments were fully collateralized, were segregated from other customers' funds, and were guaranteed by the federal government. X further stated that these securities were being held in safekeeping by a bank and that the securities could be sold at any time prior to settlement date. In fact, however, X did not purchase any GNMA securities for customers with whom it entered into "stand-by with pair-off" transactions, and no such securities were held in banks on behalf of the investors. These transactions were merely unsecured loans to X. X used the funds to pay stand-by commitment fees it owed to customers; pay fees to other customers to induce them to enter into stand-by commitments at above-market prices; repay with interest the funds owed to other "stand-by with pair-off" customers whose settlement dates had arrived; pay "finder's fees" to persons who referred customers to X; pay "management fees" to its registered affiliate; and pay its expenses, including the extremely high commissions it paid its salesmen. In addition, a substantial part of this money was retained as "profit," and X apparently also used some of these funds to invest for its own account.

In addition to the misrepresentations and omissions concerning the nature of the investment packages it was offering, X misled its customers with false statements concerning its financial situation and its status as a broker-dealer. In response to requests for information concerning its financial condition, X provided customers with a combined financial statement for it and its registered municipal securities affiliate, which was in far better financial condition than X. This statement served to conceal X's precarious financial situation. Moreover, the cover page of the financial statement contained the legend "Member Securities Investor Protection Corporation - National Association of Securities Dealers, Inc." X, however, was not a member of either SIPC or the NASD.

By mid-1979, X's financial condition had become desperate. In July - August the firm had a negative net worth of between $150,000 and $300,000. It continued to conduct business in this condition for several months, with the exception of a one-month period when the firm ceased operating because it did not meet the minimum net worth requirements of the state under whose laws it was organized. State and federal enforcement actions, and a declaration of bankruptcy, followed in late 1979. According to the most recently available financial information, X presently has about 165 open trades with about 75 different customers. These customers include credit unions, banks, savings and loan associations, trust accounts, and individuals. The firm's contractual obligations through February 1981 include repaying its "stand-by with pair-off" customers about $11.4 million in principal and about $1.4 million in accrued interest. At this point, it is unclear what the ultimate losses occasioned by X's activities will be, but based on information X has filed with the bankruptcy court, they will evidently exceed $8 million.

X contends that the stand-by with pair-off contracts were legitimate hedge transactions, and that its financial difficulties were caused by defaults on GNMA forward commitments by a New York broker-dealer and a large investor. X apparently had purchase and sale agreements with the broker-dealer covering delivery of $321 million in GNMA securities in 1979 and 1980. X charges that the New York firm unjustifiably repudiated these agreements in September, 1979. These claims are currently the subject of private litigation.

It appears that two principals and several salesmen of X may currently be continuing X's activities at a newly formed, unregistered broker-dealer establishment.

**Case #14**

Y was an unregistered government securities dealer, affiliated with a registered municipal securities broker-dealer. From mid-1977 to mid-1979, Y sold hundreds of millions of dollars of delayed delivery contracts in government securities, principally GNMAs, to a variety of customers, including small banks, S & L's, trust companies, and a substantial number of individuals. Many of these contracts called for settlement beyond six months in the future. The unregistered dealer generally attempted to cover its future delivery obligations by purchasing delayed delivery contracts from primary government securities dealers in amounts and yields sufficient to protect it from risk due to market fluctuations.

Problems arose with this hedging strategy, however, because contracts for settlement longer than 6 months in the future are generally not available from issuers or other government securities dealers. Accordingly, Y employed a strategy known as a "rolling hedge". In practice this meant that when it sold a delayed delivery contract of greater than 6 months duration, Y would purchase a contract in the same principal amount and yield but with a settlement date of 6 months or less. When the settlement date on this purchase arrived, Y would pay for the contract, immediately sell it, and use the proceeds (plus or minus an additional capital contribution, depending on the market) to purchase a second contract of a duration, yield, and principal amount chosen to cover its outstanding obligation. However, even when final settlement dates on purchases and sales were perfectly matched, maintaining the rolling hedge required very large temporary investments of capital in a declining market and, because of its thin capitalization in relation to its outstanding obligations, Y found itself with severe cash flow problems. For example, the rolling hedge itself consumed additional funds of nearly $7,000,000 during one four month period in late 1978. This would have forced Y to cease doing business if it had not employed several questionable or fraudulent business practices described below.

Y's cash flow problems were exacerbated by "coupon conversion losses" it experienced as a result of its business strategy. Y frequently engaged in repo transactions -- using GNMA collateral to raise short term working capital. In many instances it repurchased a similar, but not identical, security at the repo termination date. In several instances, a coupon rate change occurred in the GNMA market between the time of sale and repurchase, making it difficult for Y to obtain securities with the same coupon as the original collateral. A similar problem occurred with the rolling hedge strategy described above, since there were coupon rate changes between the time Y sold standbys or forward commitments and the time it rolled over the standbys or forwards it had purchased to hedge its sales. For tax and other reasons, some customers refused delivery

of GNMA's with coupon rates different than those they had contracted for, even though they offered the same yields. This forced Y to pay premiums for GNMA's satisfactory to its customers since they were no longer readily available in the market place. During 1979, these "coupon conversion" losses totalled nearly $3,000,000.

The traders at most of Y's small institutional customers were unsophisticated with respect to the government securities market. At least two of Y's customers cancelled several trades for delayed delivery and standby contracts during the declining market of early 1979 -- one of the institutions claiming that salesmen failed to disclose the risk factors associated with trading in GNMA forward commitments and standbys. Also, Y sold forward commitments of over $12,000,000 to one trust company which thereafter cancelled the contract and subsequently went bankrupt. Y absorbed a loss of almost $500,000 in connection with these transactions.

In late 1978, when Y's cash position became critical, it began selling standbys without purchasing similar standbys to hedge its position. In doing this it gained working capital since it realized the entire standby fee without having to pay a substantial portion of that fee to hedge its position. In effect, however, the dealer was betting that the GNMA market would rise so that its customers would not exercise their standbys, and it was exposing itself to a risk of substantial loss in the event the market continued to decline. In fact, the latter situation occurred, and Y lost in excess of $2 million in these transactions.

By early 1979, Y's financial situation deteriorated to the point where it engaged in outright fraudulent repo transactions to obtain the necessary capital to stay in business. On several occasions it approached two of its customers, a privately held trust and a publicly owned insurance company, and convinced them to "purchase" GNMA securities in repo transactions from unidentified "customers" of Y. The two purchasing customers paid a total of $4,200,000 in margins in the alleged repo of $157,000,000 of GNMA's during the first half of 1979. They were induced to enter this transaction by the offer of a very attractive 26-28% annual return on their investment. In fact, however, there were no selling "customers" and no underlying GNMA. In effect, the trust and the insurance company unwittingly made unsecured loans to Y, which was able to cover the deception for several months by paying the "purchasers" the profit due from the "repos" and inducing them to take part in larger and larger transactions. The true situation, however, could not long be hidden because Y's financial condition deteriorated to such a point that it could no longer maintain this facade.

In late May, 1979, Y approached the trust and the insurance company and revealed its fraudulent activity. It convinced these customers that it would be unable to continue in business without additional working capital and that the only way they could recoup their losses was to infuse an additional $5,100,000

to be repaid when Y's extensive hedge position began unwinding in late 1979. The customers acquiesced but demanded and received the right to review Y's finances and oversee its future operations. In late summer, 1979, Y was unable to repay the loans. The customers converted their debt positions to equity and replaced Y's officers and directors. Y's apparent net worth, as of August 31, 1979, was negative in the amount of about $6,500,000.

Case # 15

A now-defunct registered broker-dealer, W, with offices located in several southern cities, was primarily engaged in the business of buying and selling GNMAs but also engaged in an occasional municipal bond transaction.

In September, 1979, the SEC determined, based upon information received from the NASD and a subsequent examination of the broker-dealer's books and records, that the broker-dealer was in violation of the net capital and bookkeeping requirements of the federal securities laws. It appeared that the broker-dealer owed its customers approximately $1 million for their credit balances and did not have funds available to pay them. The broker-dealer had apparently been operating with a net capital deficiency for at least several weeks and had effected about 80 customer transactions during that period. Although the cause of the financial collapse is unclear, it appears that a major part of the problem was that interest rates rose rapidly causing the value of its government securities inventory to plummet.

W engaged in forward transactions in GNMA for its own account, and sold GNMAs to customers, including many retired persons, on a cash basis. W's salesmen, who were paid commissions as high as 45%, appear to have made misrepresentations to some customers regarding, among other things, the risks associated with GNMA transactions and the fact that the monthly pass-throughs represent a return of principal as well as interest, and therefore decline over time. There also appear to have been problems concerning timely payment of principal and interest.

A SIPC trustee has been appointed and liquidation is proceeding. SIPC has already paid approximately $3 million in connection with this case, but it may recover a portion of this expenditure from W's assets.

Case # 16

AA is a registered broker-dealer that during the period discussed herein engaged almost exclusively in municipal securities. In 1971, a small national bank with deposits of $70 million and equity of between $4 and 4 1/2 million, opened an account with AA. During 1974 and 1975, adjusted trades were made between AA and the bank. Adjusted trades are transactions at prices above the market which are designed to cover up or defer losses on portfolio securities. To hide such losses in its investment portfolio, GNMA certificates and municipal securities owned by the bank were sold to AA at prices adjusted as much as 30% above the market, and in related transactions the bank purchased new investment securities from AA also at prices above the market. During 1975, trades with the bank resulted in profits to AA of over $600,000. The bank ceased doing business with AA in 1975 at the insistence of the Comptroller of the Currency.

Losses to the bank on the transactions from 1973 through 1977 total at least $700,000 and there is an additional $1 million in unrealized losses on securities not yet liquidated as of mid-1979.

In mid-1979, the SEC, through settlement with the principals, censured AA for its activities with the bank and imposed administrative sanctions against 4 of AA's principals.

Case # 17

BB is an unregistered broker-dealer engaged in transactions in U.S. government issued and guaranteed securities. It is affiliated, and shares offices and personnel, with a registered broker-dealer.

In late 1978, BB defaulted on its reverse repo agreement to deliver a $1 million GNMA certificate to a savings & loan company ("S & L"). The S & L inquired about the status of this GNMA and about a separate $1 million government guaranteed State of Israel bond held by BB on another reverse repo and found that BB had hypothecated both securities to other lenders and was unable to redeem them. On the same day, BB defaulted on a loan secured by a government security held by a registered broker-dealer. This broker-dealer then recalculated its secured position as lender to BB in many repos and reverse repos and a few days later demanded additional security under the terms of its agreements. BB could not meet this demand and, three days later, BB filed for reorganization under the Bankruptcy Act.

An inspection of BB and its affiliate indicated major irregularities and apparent customer losses in BB's operations, but few if any major irregularities and no customer losses in the operations of its registered broker-dealer affiliate. BB utilized a simplistic and often unreliable recordkeeping system. BB also distributed false, unaudited financial statements which did not reveal its precarious financial condition. In contrast, BB's registered affiliate took great efforts to ensure that its books and records provided an accurate basis for NASD FOCUS reports, and thus achieved a far more accurate and complete recordkeeping system than that of BB.

In one category of irregularities, BB had failed to pass through monthly payments on GNMA securities held by BB for safekeeping or on repo or reverse repo agreements. Seven financial institutions and three broker-dealers were thus deprived of three months of pass-through payments on these securities, or about $240,000. In a second major category, BB hypothecated many securities that were held by it but were owned by or committed to customers or other dealers. In twenty-five reverse repos, BB had lent about $11,000,000 and had then pledged or repoed the same certificates as security on loans to itself from ultimate lenders in an aggregate amount of about $16,000,000. (BB had also pledged some customer securities that it was simply holding for safekeeping.) The difference of nearly $5 million was deposited in BB's general operating account and exhausted on operating or other expenses. BB's customers were not advised of this use of their securities nor the possibility that BB would be unable to redeem the securities or return them to the customers.

BB was declared bankrupt in mid-1979. Schedules compiled by the trustee in bankruptcy in early 1980, indicate losses of approximately $15 million to financial institutions and other broker-dealers who dealt with BB. Some creditors were allowed to liquidate the assets they held for BB against their claims. As a result, they were included as defendants in suits filed by 11 of BB's numerous remaining creditors.

BB's creditors include banks, credit unions, pension funds, savings and loan associations, generally with assets of less than $30 million, and individuals. Their claims further illustrate the practices BB engaged in. For example, one New York S & L filed a civil action alleging that, beginning in early 1977, BB borrowed about $3.5 million from it, pledging as collateral five GNMA certificates and that BB either repledged the GNMAs or disposed of them in violation of the agreement. These certificates were never delivered to the S & L. Likewise, an S & L in Texas claims that BB or its agent wrongfully sold a $300,000 GNMA certificate that was delivered as collateral and not in a sale. Finally, a registered broker-dealer claims BB defaulted on its purchases of GNMAs for forward delivery.

BB's affiliate, a registered broker-dealer, also went bankrupt, chiefly due to guarantees given on BB's transactions and not due to any sales improprieties of its own.

Case # 18

CC, an unregistered broker-dealer firm, has been engaged in the purchase and sale of U.S. government-guaranteed securities since its its inception in February, 1976. CC is an affiliate of a registered municipal securities broker-dealer. CC and its registered affiliate shared the same 12 salesmen but kept separate books and records.

In early 1977 the SEC received information from the Comptroller of the Currency and other sources indicating that the unregistered broker-dealer may have committed violations of the federal securities laws in connection with the sale of GNMA securities to a national bank. The information indicated possible violations which included unauthorized trading, a failure to disclose adequately the potential risks in certain GNMA transactions, and excessive mark-ups and mark-downs. There was no indication of any irregularities by the registered affiliate. CC has vigorously opposed enforcement of subpoenas issued in the SEC's investigation, and it is currently appealing a subpoena enforcement order of a federal district court.

Case #19

A mortgage banker and its predecessor firms have been FHA and VA approved lenders since 1971. The mortgage banker originated GNMA modified pass through certificates from early 1975 until mid - 1979, and it had more than 20 offices nationwide. The current president, chief executive officer and principal shareholder of the mortgage banker is an individual who has been in control of the firm since 1974 and is responsible for placing in the secondary market the mortgages originated by the firm.

During the period from early 1975 until mid-1979, the mortgage banker originated VA and FHA loans primarily on single family residences, pooled these loans, applied to GNMA for certification, and, after receiving GNMA certification, sold these loans. The mortgage banker would continue to service the loans which it had sold, receiving servicing income of .44 percent of the total amount of mortgages serviced. In 1978, the mortgage banker's servicing income was nearly $2,000,000 and its total GNMA servicing pool was nearly $600,000,000.

By 1978, the mortgage banker was originating and closing approximately $30 million a month in home loans. Lacking the capital to operate at this volume, it utilized "warehousing" credit arangements with approximately twelve banks throughout the United States. The warehouse banks required the mortgage banker to provide them with written commitments evidencing that it had received commitments for future delivery of the GNMA certificates. In this way, the bankers were protected from adverse interest rate changes.

The process of selling forward commitments in GNMAs or selling "short" is commonly used by mortgage bankers to "lock in" an interest rate. The mortgage banker normally sold "short" its future production and went "long", or purchased forward commitments, only to pair off certain short positions to take advantage of upswings in the market. Beginning in early 1979, however, the mortgage banker began to speculate in the GNMA forward market. Over a period of approximately 3 months, the mortgage banker entered into forward commitments with 12 securities dealers. The size of the positions taken by the mortgage banker were greatly in excess of the normal hedging activity and the "net" position the mortgage banker held was a long position obligating it to take delivery rather than a short hedging position.

During a two month period in early 1979, the mortgage banker's net position ranged from $180 million to over $350 million long. With $75 million in GNMA settlements coming due in mid-April, the mortgage banker called a meeting with the customer-dealers and told them it could not honor its commitments. The customer-dealers, although attempting to minimize their losses, incurred losses of approximately $5.2 million. Of this amount, approximately $3 million was repaid pursuant to the terms of a settlement between 11 of the customer-dealers and the mortgage banker.

In addition, during this period, the mortgage banker was receiving the proceeds from the sale of GNMA's and failing to remit them promptly to its warehousing banks. When the banks learned of this failure to honor its commitments and foreclosed on the loans pledged as collateral, they discovered they were approximately $8.6 million short. The mortgage banker subsequently agreed to pay the banks this entire amount pursuant to the terms of a settlement agreement. 4/

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4/ The large losses suffered by the banks were partially a result of misrepresentations that loans would be paid promptly upon receipt of payment of a GNMA certificate, and partially due to lack of diligence on the part of the banks in ensuring that they were properly collateralized and that the mortgage banker promptly paid them. In addition, new GNMA regulations, effective April, 1979, required banks to release any security interest on loans for GNMA pools at the time the certificates are issued.

The mortgage banker was able to obtain such a large net long position in the market for three reasons. First, although it was "long" with 12 seperate dealers, it falsely represented to each dealer that it was long only with that dealer, and was net short because it had short positions with other dealers. It also represented it was buying from only one or two other dealers. Second, the mortgage banker and its CEO were viewed by all the dealers as sophisticated investors, both because the mortgage banker had a servicing portfolio of nearly $600 million in GNMA mortgages, and because the CEO had apparently made money in speculating in GNMA's in the past. Third, the absence of a mark-to-market or margin maintenance requirement allowed the mortgage banker to acquire a large position without posting any funds or having any limit imposed on it. As a result of these three factors, a number of firms sold large amounts of forward commitments to the mortgage banker that would otherwise appear unsuitable, resulting in the latter's having, on the date of its defaults, forward commitments to buy GNMAs from customer-dealers totaling $75 million. When these commitments started coming due for settlement, the mortgage banker was unable to "pair them off", did not have sufficient funds for settlement, and defaulted.

Prior to the actual default by the mortgage banker, it had attempted unsuccessfully to enter into reverse repurchase agreements with a number of the dealers in order to roll over the contracts due for settlement. After the default, the proceeds from the sale of the mortgage banker's servicing contracts netted about $7.1 million and the mortgage banker was therefore able to pay its banks 100% of their losses, and its dealers, 65%.

In May, 1979, GNMA revoked the mortgage banker's issuer/servicer status. Nevertheless, the mortgage banker continues to originate FHA and VA loans and is selling them to one customer that is creating GNMA pools.

Case # 20

DD has been a registered broker-dealer since 1975 and is primarily engaged in the sale of government and municipal securities. It has nineteen salesmen and 190 active customers. A substantial portion of DD's business has consisted of the offer and sale of forward commitments to purchase GNMA securities. DD stopped selling GNMA forwards in February, 1979, because of a declining market and net capital problems, but has resumed as of January, 1980.

In early 1979, three savings and loan associations and a bank that had traded with DD charged that one of its salesmen had executed unauthorized trades

of GNMA forwards for their accounts. At that time the four customers' accounts already showed unrealized losses of approximately $400,000 on GNMA forward transactions involving commitments of $13 million. Although it received written notice of the customers' intention not to honor these GNMA contracts, DD failed to deduct the unrealized losses from net capital as required by rules promulgated under the Securities Exchange Act. DD also failed to take the other required deductions in computing its net capital.

DD's net capital deficiencies were discovered shortly after the customers' notices as a result of a complaint one of the customers filed with the SEC, and an SEC inspection conducted immediately thereafter. When informed of deficiencies amounting to $703,755, DD immediately ceased conducting business. It then entered into an agreement with a primary dealer whereby the dealer assumed the obligation for the $13 million in GNMA forwards in consideration of future underwriting revenues. This assignment remedied the net capital deficiencies and DD resumed business shortly thereafter. None of the four customers lost money on the apparently unauthorized transactions, since DD assumed the losses. The salesman is no longer employed by DD.

It should be noted that the four customers had been trading GNMA forwards for two or three years and apparently understood the market. They had also made repeated transactions with the salesman accused of the unauthorized trading. In disclaiming the subject transactions, the customers pointed to the fact that they did not sign the authorization forms usually sent out by DD on such trades. The salesman, however, claims that these transactions were orally authorized by the banks and that the banks repudiated the trades because of the drop in the market at the time. It is also noteworthy, however, that DD had been having net capital problems for some time and that it was only pursuant to a previous settlement agreement with the SEC that DD subjected its government securities transactions to the requirements imposed on its registered broker-dealer activities.

case #21

A registered broker-dealer and certain of its unregistered affiliate dealers transacted business in GNMA forwards and other government issued and guaranteed securities for forward delivery primarily with small and medium sized credit unions and savings and loan associations. The dealers' salesmen were, for the most part, inadequately trained and lacked experience in the

securities field. These salesmen generally did not inquire as to the financial condition or investment objectives of these instututions. They represented that profits were virtually certain to be earned with no margin deposit or cash payment, or the necessity of taking delivery. They often neglected to mention, or misrepresented, the market and credit risks inherent in the securities offered. Portfolio managers invested heavily in these securities, often well beyond their financial ability to fund or beyond in-house trading limits of the dealer. For example, one small federal credit union, at one point, had an amount of commitments in these securities equal to 3/4 of its total assets.

When interest rates began to rise, these institutions, fearing large losses and the inability to fund securities at settlement, turned for relief to various techniques suggested to them by the dealers' salesmen. One technique used by over a dozen customers was adjusted fee trading. Under this approach, one of the dealers would buy back a security sold for forward delivery at the original contract price, i.e., a price above the then current market, and simultaneously sold (sometimes from a short position) the customer another security for forward delivery at a price over the market by an amount equal to the loss involved in the original contract. The customer was also required to pay an additional charge which the dealer used to cushion its loss on the original contact. Several salesmen advised their customers to post the loss mark-up and charge on their books as an asset, thus deferring the loss at least until the settlement date for the second commitment. By then, salesmen told their customers, prices would rebound enough to cover these amounts. Unfortunately, prices continued to decline and some institutions lost thousands of dollars in charges when securities were liquidated at prices lower than their original cost. Confirmations sent by the dealer to its customers seem to have masked the economic substance of the transaction by indicating that the settlement had simply been extended at the original contract price.

Investors also started transacting reverse repos with the dealers when they found themselves with a market loss or with insufficient funds to pay for securities at the delivery date. The investor would receive the coupon interest on the security sold to the dealer and pay a financing fee to the dealer. As interest rates rose and repos were rolled over, market value of the securities continued to decline and the fee often exceeded the coupon rate. As a result, several savings and loan associations found themselves with large losses and sometimes in violation of FHLBB borrowing limitations. The dealers also seem to have sold these securities at a price higher than the prevailing market in a number of cases.

Although it is difficult to quantify losses at this time, a substantial number of institutions have realized or unrealized losses in excess of $50,000, a few with losses of at least $250,000.

Case #22

An unregistered affiliate of a registered broker-dealer seems to have engaged in adjusted trading with certain of its customers. These customers, savings and loan associations and credit unions, had purchased GNMAs and Federal Home Loan Mortgage Corporation Participation Certificates (PCs) for forward delivery and had significant losses resulting from a decline in the market price. Some of these customers were induced to purchase these forwards because of the payment of "up-front" money by the dealer. In this case, the affiliate, often at the customer's request, would pay one point (1% of the principal amount of the transaction) to its customer shortly after the trade date and raise the price of the security by one point over the current market price. The customer then booked as income some or all of the "up-front" fee, even though the customer sometimes liquidated its obligation at a loss before settlement date. The recognition of "up front" payments apparently materially increased customer income.

The affiliate was also involved in questionable or improper activity in connection with sales of forward commitments where no money initially changed hands. In some instances, customers incurred unrealized losses because of a decline in market price and the affiliate, at or about the settlement date, confirmed the buy-back of the securities at the original higher price which the customer had agreed to pay. Simultaneously, the affiliate either "sold short" or "long" to the the same customer forwards or securities with the same principal amount and coupon, which it purchased in the market, at the lower market price, with a future settlement date. The affiliate confirmed sale of such securities at the higher original transaction price to the customer for later settlement. This type of transaction required the customer to pay a mark-to-market fee to the affiliate, which was disguised as an advance payment on the new contract, instead of being shown as a loss. Often the customers were unaware of these "adjustments"; rather, they believed that they were just extending their settlement dates.

In addition, one customer of the affiliate apparently sustained additional losses when it over-extended itself by entering into reverse repos with the affiliate's unregistered parent.

Millions in realized and unrealized losses were incurred by the customers of the affiliate and its parent.

Case # 23

Three complaints have recently been filed concerning an unregistered government securities affiliate of a registered broker-dealer. A federal agency, which had responsibility for administering certain trust funds, was a customer of the unregistered affiliate. The agency purchased, in November of 1978, approximately $760,000 worth of FMHA loans from that firm but never received the supporting documentation. In February, 1979, a bank in Mississippi and a federal credit union in Pennsylvania purchased approximately $150,000 and $200,000, respectively, of these same securities and likewise never received any supporting documentation.

Upon initial inquiry, it seems that the unregistered affiliate purchased the loans for its own account from an issuing bank in Florida and resold them to the complaining customers. The customers wired their money to the firm's account at a New York bank, but the issuing bank filed for bankruptcy during this period and did not deliver the notes to the unregistered affiliate. To escape liability on the sales contracts with its customers, the unregistered affiliate is now claiming that it acted as agent for the customers and not as principal.

While the facts of the case are not clear, it appears that the unregistered affiliate may have been over-extended in GNMA commitments and was therefore unable to meet its commitments when the issuing bank defaulted. It is also worth noting that the acknowledgments and confirmations sent by the unregistered affiliate gave no indication of whether the dealer was acting as principal or agent in the purchases although confirmations for transactions in non-exempt securities are required to contain this information. Confirmation rules applicable to non-exempt securities require the dealer to state his status in the transaction.

The total amount of funds involved in the three complaints is $1,100,000. At this time it is not known whether other customers were affected or what the ultimate losses will be. On December 21, 1979, the unregistered affiliate filed for bankruptcy.

Case # 24

NN is a small regional broker-dealer, a NASD member, and not a member of any exchange, although it clears through a member firm. Since 1975, NN has specialized in publicly traded municipal and other government bonds.

From January 1976 until October 1976, NN acquired approximately $2 million of Tennessee Valley Authority ("TVA") Bonds and sold them to more than 300 customers. NN actively marketed these bonds by means of newspaper and radio advertisements. Most sales transactions were conducted by the phone. Neither NN, nor its registered principals, ever informed their customers that these TVA bonds were callable. 5/ Shortly thereafter, customers lost approximately $73,400 when TVA exercised its redemption clause. Thus customers lost the difference between the premium price they paid and the lower redemption price.

Seventy-five percent of NN's new business was generated by its advertising program. NN ran about four or five newspaper advertisements per week. During the summer of 1976, NN advertised certain energy related revenue bonds as being "guaranteed by a U. S. Government Agency," when no such government guarantee existed. Finally, NN ran advertisements giving false yields on Government Services Administration Bonds. Apparently, no losses to customers resulted from these activities.

In early 1977, the NASD filed a complaint against NN and its two registered principals. They were found guilty of fair practice violations regarding NN's advertising activities. All respondents were censured, one principal was suspended for three years, and the other principal was barred from being a registered principal and fined $5,000. A subsequent SEC administrative proceeding was based on NN's lack of disclosure of pertinent information on the TVA bonds and inaccurate advertising on the GSA bonds. The SEC suspended the firm and its principals for various periods of time, required new supervisory procedures, especially regarding advertisements, and required the firm and the principals to disgorge to the bond purchasers profits made on these transactions.

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5/ Bonds are callable when the issuer reserves the right to redeem the bonds prior to maturity. Such a provision may require the issuer to pay some amount over par, the amount over par being referred to as premium. In this case, TVA paid 106.3 on redemption. During the period of the sales campaign, NN was selling these bonds at a premium greater than 106.3.

Case # 25

Two employees of a regional office of a major registered broker-dealer apparently engaged in unsuitable trades, churning, misrepresentation and a fraudulent course of conduct in GNMA transactions. The investors involved were generally unsophisticated and included an elderly retired school teacher who was allegedly strongly encouraged by the registered representative into opening a margin account and making purchases in, among others, GNMAs. Apparently as a result of active trading in her account, the value of her portfolio declined from over $200,000 to about $28,000 in one year's time.

In addition, the second employee, a vice-president at the same regional office, apparantly encouraged a second investor to buy a $1 million GNMA after falsely saying that he had already purchased it for the investor's account. The salesman seems to have made made certain misrepresentations to the investor and failed to state other material matters, including the cost of the security, his interest costs and the commission charge of $16,534. This investor is claiming a loss of $120,000 since April, 1978, and has filed an action against the registered representative and the broker-dealer.

A third investor, a retired contractor, was seeking a risk-free investment with a 9% or better return. The registered representative reportedly told the investor that a purchase of certain GNMAs could yield a 19% return, made misrepresentations as to the costs the investor would incur on his margin account, and gave the investor unauthorized and misleading sales literature. Subsequently, the investor, contrary to the registered representative's advice, sold at a loss of approximately $60,000.

A fourth investor, an elderly businessman who had just sold his business upon retirement, invested $9,911,000 in GNMAs for his and his wife's trust accounts. The registered representative told him that such a purchase could yield a 19-21% return and was risk free. This investor lost over $2.6 million in 15 months. Total losses aggregate $3 million.

Case # 26

MM is a family-controlled corporation approved as a trust company in 1964. As a trust company, it is supervised by a state banking commission. Its primary business is the investment of funds deposited by the public. MM also functions as a trust company for individuals and businesses. The company is now insolvent, having filed a voluntary petition for bankruptcy in December, 1978.

MM solicited deposits from the public and issued certificates of deposit and passbook accounts. In its sales literature, MM acknowledged that its deposits were not insured by the Federal Deposit Insurance Corporation but represented that its depositors had comparable security because it had a fidelity bond which protected against losses from embezzlement, and because it engaged only in the safest possible investments. MM received $7 million in deposits from 850 investors, most of whom have incomes in the $20,000 - $30,000 range. In addition, a large number of investors were retired individuals who were attracted by the advertised safety of MM's investments.

Contrary to its representations, however, MM used these funds for speculative investments in GNMA forward commitments and other securities. In addition, some of this money was apparently diverted to the accounts of insiders. Its total assets now amount to $5.2 million, but a significant portion of this amount is pledged for financial transactions. In addition to the money it owes investors, MM has outstanding commitments totalling $14 million in connection with GNMA forward transactions.

Although the state banking commissioner, in May 1977, prohibited all state trust companies from trading GNMA forwards, MM continued to participate in this market. 6/ In late 1978, MM had open transactions involving $7 million worth of GNMA forwards and $7 million of Treasury securities with a registered New York broker-dealer. MM, however, could not afford to pay for these securities, and on settlement date, entered into reverse repurchase agreements with the broker-dealer. After the banking commissioner discovered $1.4 million in losses in connection with these transactions, MM directed another government securities dealer to sell the $7 million in GNMA's, but did not inform the dealer that these securities were collateral being held by the New York broker-dealer in connection with the repurchase agreements. The $7 million in Treasury notes were apparently sold by another dealer. MM attempted to conceal these losses by manipulating the entries on its uncertified financial statements. In November and December 1978, in an apparent attempt to recoup its losses, MM purchased about $14 million in GNMA forwards. At the end of December, however, MM filed for bankruptcy, and has defaulted on these transactions. These defaults resulted in a losses of more than a half million dollars to several dealers, one of which was already experiencing severe cash flow problems and is now the subject of an SEC enforcement action. It appears that MM's depositors will lose approximately $4 million as a result of its insolvency.

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6/ MM claims that it never received the letter which the banking commmissioner mailed to inform it of the new prohibition on GNMA trading.

Case # 27

JJ is a credit union formed in 1976 to function as a central credit union for several small credit unions. JJ acts primarily as a "reserve bank" for the member credit unions by investing their excess funds and by providing short term loans during periods of heavy demand by its members. In early 1977, during a period of rapid growth, JJ hired a new president and investment manager, who began to invest heavily in GNMA forwards and other government-guaranteed securities through three registered broker-dealers. At two of the firms, JJ's trades were routed through separate, unregistered affiliates of those registered broker-dealers which dealt only in government securities.

JJ's new manager instituted an aggressive "trading strategy," which was designed to take advantage of daily shifts in market prices, and which frequently involved buying and selling the same security several times in the same day. In addition, the manager purchased large amounts of GNMA and FHLMC forward commitments anticipating that increased member deposits would enable JJ to take delivery of these securities on their settlement dates.

Credit union member deposits did not grow as quickly as anticipated, however, and when interest rates began to rise, JJ had commitments to take delivery of large amounts of securities several points above market, but was without sufficient funds to take delivery. In order to postpone delivery of these securities, JJ entered into a series of reverse repo agreements, including dollar price reverse repurchase agreements, 7/ with its dealers, hoping that (1) interest rates would fall and it would be able to resell the securities at a gain or at a smaller loss, or (2) increased member deposits would enable it to take delivery and hold the securities in inventory. This strategy failed because interest rates remained high and member deposits did not increase sufficiently. As a result, state banking authorities had to step in with additional funds to prevent JJ from defaulting on obligations of $5 million coming due in October, 1979, and $18 million coming due in November, 1979. JJ recognized a loss of $1.8 million as a result of these forward commitments.

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7/ Under these dollar price reverse repurchase agreements, the credit union would fund the purchase of securities by selling them back to the dealers on settlement date and agreeing to repurchase securities with an equivalent yield on a date in the future. The lending dealer could sell or otherwise dispose of the securities it purchased from the credit union, and then was required to obtain securities with an equivalent yield to resell to the credit union upon maturity of the repurchase agreement.

In the course of its trading in government-guaranteed securities, JJ was dealing with three different dealers, and was doing considerable business with two of them. The dealers contend that JJ and its manager were sophisticated investors, pointing out that JJ had been successful in day trading and that, although it incurred losses from its heavy forward commitments, everyone who had forward commitments in government-guaranteed securities took losses when the interest rates continued to rise. Nevertheless, the sale of forward commitments to JJ may have been unsuitable for that entity. Further, although one of the dealers required JJ to maintain securities with it in a margin account, the others did not. Thus, as a practical matter, there was no limit on the amount of forward commitments on which JJ could be obligated. Despite JJ's very rapid growth, it was still overcommitted to purchase securities in the forward market. Substantial forward commitments such as these exposed the credit union to undue market risk, notwithstanding the apparent sophistication of JJ's manager.

Case #28

An unregistered broker-dealer was created in late 1978 with approximately $4.5 million in capital to deal in government and government-guaranteed securities in a so-called matched book. 8/ During its short existence, the partnership engaged primarily in GNMA repurchase ("repo") and reverse repurchase ("reverse repo") agreements. The partnership consisted of three largely passive partners who provided most of its capital and one active partner who conducted trading and managed operations. Within a year of its inception, the firm did business with hundreds of both sophisticated and unsophisticated investors, including a state, a political subdivision, banks from South Carolina to New York, savings and loan associations, and mortgage bankers.

Approximately six months after the firm was formed, the active partner, apparently without the knowledge of the others, opened the first of three trading accounts for himself under fictitious names. His apparent purpose was to enable himself to trade without having to provide any capital. Six months later the firm declared bankruptcy. These losses were apparently attributable, at least

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8/ In a matched book, a dealer, acting for its own account, engages in an equal number of purchases and sales of the same securities, thereby limiting its risk and the amount of capital required. Profits are derived chiefly from the spread between the purchase and sale prices and from the differences between the interest rates.

in part, to the three nominee accounts and to unsecured loans made by the broker-dealer to its partners.

Based on a very preliminary information, it appears that the active partner purchased large quantities of securities without sufficient funds with the expectation that interest rates would go down. In addition it appears that the other partners learned of the firm's large trading losses approximately two months before the declaration of bankruptcy, but nevertheless allowed the firm's employees to continue making new commitments during this period.

When the firm declared bankruptcy, it had commitments of approximately $130 million dollars in repo and reverse repo agreements. When the firm declared bankruptcy, its liabilities exceeded its assets by $11.5 million. It is impossible to determine who will eventually suffer the losses, but there were approximately 40 persons which had open positions with the firm when it declared bankruptcy, including registered dealers, unregistered dealers, local governments, and savings and loans associations.

# CHAPTER V

## REVIEW OF RECENT ACTIONS BY FEDERAL REGULATORS AND INDUSTRY PARTICIPANTS TO REDUCE ABUSIVE TRADING PRACTICES

In response to the problems that developed in markets for federally guaranteed mortgage-backed securities, regulators of financial institutions have issued guidelines for investment activity in these securities, particularly activities in futures, forward and standby agreements to acquire these securities. These guidelines principally involve revised accounting procedures, margin maintenance requirements, and restrictions on taking positions in delayed delivery contracts.

The National Credit Union Administration has introduced stringent regulations applicable to all federally chartered credit unions. The rules prohibit credit unions from dealing in standbys and forward transactions of more than 120 days. Further, the rules define permissible repurchase agreements and reverse repurchase agreements. Credit unions must also mark forward positions to market on their financial statements.

The Federal Home Loan Bank Board introduced rules in 1979 limiting forward positions to a specified percentage of assets. They also announced overtrading (adjusted trading) and recordkeeping regulations.

The Comptroller of the Currency, Federal Deposit Insurance Corporation, and Federal Reserve, the three agencies which supervise the nation's commercial banks, announced a joint policy statement near the end of 1979. The agencies set forth a number of precautionary rules which are designed to confine bank activity in forward and standby contract activities to safe and sound banking practice. Included was a rule describing how mark-to-market requirements are to be applied.

GNMA (HUD) has required issuers of its securities to observe prudent business practice rules since October 1977, including instituting certain internal management controls and applying net capital requirements. GNMA has also recently introduced regulations applicable to issuers pertaining to suitability, mark-to-market, and margin requirements for GNMA forward transactions.

The problems in trading government-guaranteed securities also prompted attention from several other agencies including the SEC, Treasury, and Federal Reserve. A number of the problems involved violations of the anti-fraud provisions of the securities laws and in some of these instances the SEC was able to bring its enforcement powers to bear on the individuals and entities involved once the violations had occurred and were discovered. The Treasury and its fiscal agent, the Federal Reserve Bank of New York, have also increased their surveillance, mainly through the primary dealers that make markets in U.S. government securities. Some states also have statutes or regulations that govern trading of government-related securities by persons within their jurisdictions. Moreover, some individual dealers have taken initiatives and independently applied more stringent regulations on their activities. The sections which follow discuss the various initiatives taken by government agencies and private participants in greater detail.

<u>Surveillance by the Federal Reserve and Treasury</u>

While markets for U.S. government securities have traditionally been exempt from formal regulation, the Federal Reserve System and the Treasury Department, both with vital interests in maintaining a healthy

market for U.S. government securities, have exercised an active surveillance role. A prime interest, of course, has been maintenance of a market which facilitates the efficient financing of the government's activities. Secondly, this is the market in which national monetary policy is executed and which uniquely enables the U.S. to manage its monetary activities. Thirdly, the Treasury securities market is the cornerstone of the U.S. capital markets and its health is vital to the effective functioning of the credit markets in the U.S.

The Federal Reserve and the Treasury have assigned day-to-day responsibility for the surveillance activities to the System Account Manager for Domestic Operations located in the Federal Reserve Bank of New York. The surveillance activities of the Federal Reserve Bank of New York focus on the approximately three dozen primary dealers in government securities, through which the Federal Reserve typically conducts open market operations. Dealers that have a trading relationship with the Federal Reserve or who aspire to this relationship are required to report daily their positions and volume of transactions in Treasury, government-related mortgage-backed securities, and federal agency securities; with supplementary reports on a weekly and semi-monthly basis. These reports also include forward commitments in GNMA securities covering a broad range of maturities. Reporting dealers also submit data on their financial status every month. Apparently as a matter of prudence, many investors will do business only with dealers that are on the Federal Reserve's reporting list, which provides strong incentive for dealers to seek qualification as reporting primary

dealers. During 1979 this group of dealers reported average daily transactions in U.S. government securities of $13.2 billion and an additional $2.7 billion in Federal agency securities. There are no data available on the total amount of government securities traded elsewhere.

The position and trading volume reports provide the Federal Reserve with basic information on supply and demand conditions in the markets for the securities on which they require reports and on dealers' exposure to market risks. Because the dealers provide daily information with virtually no lag, the Federal Reserve can spot significant changes in a dealer's position on a timely basis.

The dealer reporting system was established on a comprehensive basis in 1960. The reporting system was revised this year to adapt it to the changes that have occurred in the market. Reporting of forward, future and optional delivery transactions in U.S. Treasury securities was introduced or improved, permitting the monitoring of such activity to be more precise. Unusual or outsize activity in forward commitments of standbys will now be more evident, and it will be possible to undertake follow-up discussion or corrective action, if needed, in a more timely way. More useful information on repurchase agreements and reverse repurchase agreements with respect to these securities is now requested. In addition, the reports continue to show positions in major security types and maturities. The volume of transactions is reported for each security type and maturity and by broad categories of customer type.

The Federal Reserve Bank of New York also asks dealers to submit an informal monthly financial report which indicates their profit or loss

from operation. A more comprehensive annual report drawn to Federal Reserve specifications is also submitted. This financial information provides a good measure of the health of members of this important industry. Dealers are judged on their ability to carry the positions to which they are committed, and potentially unsound positions are discussed with dealers.

The Federal Reserve's large scale daily market activity also contributes significantly to its surveillance program, because it provides additional information on the operation of the market. This participation reveals not only how the market arranges transactions, but the relative efficiency of delivery and accounting practices, the methods of resolving problems and misunderstandings, and the reasons underlying existing market practices.

In addition to the dealer reporting process and on-going involvement in the market, the Reserve Bank holds three or four meetings daily with individual dealer firms at the Reserve Bank. Senior officials, traders, and sales people of the dealer firm informally discuss their views of the market, latest trends in the industry, and developments within their firms, as well as information they have obtained from customers. Telephone contact with traders routinely takes place throughout the day and is another important means of communication and source of information.

Visits to dealers to observe their operations are also an integral part of surveillance by the Federal Reserve. While such visits are not intended to be audits, they do include a review of the systems dealers use to prepare their reports to the Federal Reserve. The visits also provide

additional information about the characteristics of each dealer's operations, practices, and trading techniques.

Regulatory Actions of the Comptroller, the Federal Reserve, and the FDIC

On November 15, 1979, the three federal bank regulatory agencies issued a joint policy statement that set out precautionary rules and specific guidelines for commercial banks and mutual savings banks engaging in financial futures and forward contracts, including standbys, for Treasury and agency (including GNMA) securities. 1/ The statement became effective January 1, 1980, and all requirements except the accounting guidelines were applicable to contracts outstanding at that time as well as to subsequent contracts. The accounting guidelines in the statement were applicable only to those contracts entered into after January 1. Comments on the action were invited, and the Interagency Coordinating Committee revised the guidelines somewhat in response to comments received.

The joint statement was in two parts. The first provided "precautionary rules" for banks engaging in futures, forward, and standby contracts. The rules set down the general guideline that safe and sound banking practices should be followed. To fulfill this objective, banks should avoid unreasonably large transactions that are not related to the bank's business needs, and such contracts should decrease, rather than increase, interest rate exposure. Limits on the size of contracts should be set and enforced

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1/ See Policy Statement Concerning Forward Placement or Delayed Delivery Contracts and Interest Rate Futures Contracts (44 F.R. 68033, November 28, 1979; revised March 20, 1980).

by the bank's board of directors. Standby contracts calling for settlement in excess of 150 days would be viewed by the agencies as being inappropriate for banks and should not be issued by banks except in special circumstances.

The second part of the statement of the banking agencies provided specific guidelines for the internal control of banks engaging in futures, forward, or standby transactions and for the accounting of such transactions. The guidelines require, for example, that a bank's board of directors endorse specific written policies in authorizing these transactions. A key guideline, and the one generating the most comment, concerned valuation requirements: ". . . all open positions should be reviewed and market values determined at least monthly (or more often, depending on the volume and magnitude of positions), regardless of whether the bank is required to deposit margin in connection with a given contract." In addition, banks were given the option of marking futures and forward contracts at either market value or the lower of cost or market. Whichever option is selected should also apply to securities delivered under a contract, and the accounting method should not conflict with the procedures followed for these contracts held in the bank's trading department. Moreover, because of the nature of forward and standby contracts, any loss on these open contracts should be recognized, at least monthly, on the basis of the lower cost or market value.

The statement exempts mortgage banking activities from the accounting guidelines since the accounting profession has already instituted appropriate accounting procedures for these activities. (AICPA Position No. 74-12). In mortgage banking operations, financial contracts tend to be used in a more

traditional hedging of inventory fashion which is not inconsistent with the regulatory agencies' view concerning what constitutes appropriate banking practices.

Regulations of the Federal Home Loan Bank Board

The Federal Home Loan Bank Board regulations regarding forward commitments of all FSLIC-insured institutions became effective June 1, 1979 (12 CFR 563). The rules were promulgated to curb the speculation in mortgage-backed securities which had resulted in large losses for some savings and loans.

The FHLBB regulations permit S&Ls to book mortgage-backed securities at cost, and presently do not require them to mark open forward commitments to market for accounting purposes during the commitment period. The current regulations define a forward commitment to be a firm or optional contract to buy securities in 30 or more days after the contract date. Institutions with net worth under 5 percent of assets can have outstanding forward commitments of up to 10 percent of assets, while those with net worth over 5 percent of assets are permitted to carry forward commitments up to 15 percent of assets. The rules also generally require forward activity to be conducted on a prudent basis and allow the FHLBB to prohibit forward trading for individual S&Ls unable to fund commitments when due.

Another provision, aimed at adjusted trading, prohibits S&Ls from selling a forward commitment or security under an agreement to purchase another forward commitment or security at a price other than actual market price. This adjusted trading provision does not address repurchase agreements, which

are viewed as involving borrowings, not purchases of securities. The FHLBB regulations specify that repurchase agreements are to be treated as purchases and sales in cases where the securities purchased and sold are substantially dissimilar. Moreover, to eliminate the practice of avoiding recognition of losses by extending a previously established settlement date, the FHLBB requires profit or loss related to disposal or modification of a forward commitment on or before the settlement date to be recognized at the time of the disposal or modification.

Under current regulations, fees received for firm or optional commitments are to be recorded according to "generally accepted accounting principles." On January 26, 1979, the Financial Accounting Standards Board Board of the AICPA approved release of an "Auditing and Accounting Guide for Savings and Loan Associations." The guide provides that commitment fees related to forward transactions should be deferred and amortized over the combined commitment and loan period to the extent that such fees exceed underwriting costs.

The FHLBB regulations require the minutes of the board of directors of each S&L to include the names, duties, and limits of authority of the institution's personnel that are authorized to engage in forward commitment transactions for the S&L's account. The minutes must also list the brokerage firms with which authorized S&L personnel can conduct forward activity and the dollar limits of transactions with each firm. A record must also be kept of the type (firm or standby) of each contract; the commitment date; amount, rate, price to be paid at settlement; market price at date of commitment; settlement date;

commitment fees received; date and manner of disposal; sales price and market value at disposal if disposition is made on or prior to settlement date other than through funding; and the seller's identity and confirmation. In addition, S&Ls must be able at all times to document their ability to fund all outstanding forward commitments when due.

Regulations of the National Credit Union Administration

The National Credit Union Administration has authority to regulate the investment activities of credit unions under Section 107 of the Credit Union Act (12 USC 1757). NCUA published its current regulations on July 20, 1979 (12 CFR 703.3), providing the most stringent rules of any of the federal financial institution regulators regarding delayed delivery contracts and repurchase agreements. The rules apply only to federally chartered credit unions and not to federally insured State-chartered institutions. NCUA relies on individual State supervisory agencies to regulate the institutions in their jurisdiction, under NCUA scrutiny.

Subject to approval by NCUA on a case-by-case basis, the July 1979 regulations permit credit unions to enter into forward commitments to purchase securities when delivery is to be made up to 120 days from the trade date, stating that such transactions "will assist in the sale of mortgage loans secured by real estate and will not subject federal credit unions to undue or excessive market risk." A credit union can enter into a forward contract to purchase securities only if it has a written cash-flow projection verifying its ability to buy the security. A credit union cannot enter into a forward contract to sell a security unless it has that security in its portfolio. All

forward agreements must be settled in cash on the settlement date and cannot be extended or rolled over into new contracts that would extend the settlement date. Credit unions are prohibited from engaging in short sales and in transactions in the futures markets. A credit union cannot sell its real estate loans under a standby commitment. 2/

An NCUA Interpretive Policy and Policy Statement dated August 23, 1979, requires credit unions, in cases where a contract calls for delivery in more than 30 days, to mark the securities to the lower of cost or market value on the settlement day. In addition, it requires such contracts to be similarly marked and footnoted in financial statements that are prepared during the period when the forward contract is outstanding.

The regulations distinguish between "loan-type" and "investment-type" repurchase agreements, because the Credit Union Act (12 USC 1757(5)) provides that federal credit unions can make loans only to their members, other credit unions, and credit union organizations, at an interest rate not to exceed 1 percent per month. In order to qualify as an investment-type repurchase

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2/ When it proposed the investment rules on October 17, 1978, NCUA would have prohibited credit unions from entering into any agreements to purchase or sell securities with deliveries in excess of 5 days from the trade date, but, on final promulgation of the rules, NCUA (1) replaced the absolute prohibition on forward trades with restrictions that allow forward trading subject to the above described limitations and (2) in order to accommodate the usual new issue cycle of Treasury and agency securities other than mortgage-related issues, changed its definition of immediate delivery to encompass a period of up to 30 days after the trade date. The earlier 5-day definition for cash sales, together with the prohibition on forward purchases, would have nearly eliminated credit unions as investors in Treasury and Federal agency securities on original issue, since the "when issued" period between the sale and issue date for these securities usually involves a somewhat longer period.

agreement, the credit union or its agent that purchases the security under an agreement to resell must take physical possession of the security. There can be no restriction on the transfer of the security purchased by the credit union and it is not required to deliver an identical security upon resale. The purpose of investment-type repurchase agreements is to earn a specified rate of interest for a short period, not to exceed the 120-day limit on forward agreements.

Reverse repurchase agreements are subject to the general limitations that credit union borrowing cannot exceed 50 percent of paid-in and unimpaired capital and surplus, and that the amount of funds obtained by means of a single reverse repurchase agreement for investment is limited to a maximum of 10 percent of paid-in and unimpaired capital and surplus. The rules prevent credit unions from putting short-term securities out on repurchase agreement to finance a purchase of long-term securities. Investments made with funds obtained through a reverse repurchase agreement or securities collateralizing the transaction must have a maturity date no later than the repurchase date.

GNMA Regulations of Issuers of Mortgage-Backed Securities

GNMA has authority under Section 306(g) of the National Housing Act (12 USC 1716 et seq.) to regulate the business practices of issuers of securities that it guarantees. The GNMA Mortgage-Backed Securities Guide governs the specific terms of issuance and guarantee of GNMA mortgage-backed securities, and since late 1977 it has prescribed prudent business practices for GNMA issuers. The prudent business practice rules require issuers to establish procedures to assess the financial integrity of securities dealers and investors

with whom they conduct transactions. The rules also require issuers to establish internal management controls to assure coordination of commitment activities, to avoid excessive forward commitments, and to assure competence and integrity of its staff.

GNMA did not mandate specific rules for issuers to use in assessing the financial soundness of securities dealers and investors, but it did suggest the following procedures: (1) review of financial statements and assessment of the adequacy of dealers' and investors' capital; (2) checking of references on the dealer or investor firm; (3) review of a general resolution of the governing body of the dealer or investor, naming individuals who are authorized to conduct GNMA transactions; (4) recording terms and conditions of commitments; and (5) familiarization with the trading practices encouraged by the securities industry and review of whether individual dealer firms follow those practices.

The internal management controls required by GNMA include (1) written designation of persons responsible for marketing GNMA securities; (2) restriction of authority to designated persons to enter into mortgage-backed securities commitments on behalf of the issuer; (3) keeping records of each transaction for at least one year, including the type of security to be delivered, date, dollar amount, coupon rate and price, a notation of whether delivery is mandatory, and the name of the firm and individual with whom the commitment was made. The issuer's net position must also be calculated and recorded at least once per week.

Under GNMA rules issuers must be prepared to report on demand to GNMA. Each month GNMA makes a written demand on 25 issuers, selected at random, for evidence of compliance with the prudent business practice require-

ments. In addition, GNMA has contracted with the Federal National Mortgage Association to conduct on-site visits with issuers in order to assure compliance with GNMA rules. Each issuer is visited approximately once every two years.

In October 1979, GNMA issued regulations that tied issuers' required minimum net worth to (1) the amount of mortgage-backed securities that the mortgage banker has outstanding and (2) the amount of its commitments for guarantees obtained from GNMA. An issuer of modified pass-through securities, the predominant type of GNMAs--must have a net worth of at least $100,000. That amount grows with increases in the amount of securities that the issuer has outstanding or in production. There is no upper limit on the requirement.

The GNMA Mortgage-Backed Securities Guide states that issuers must hold their required net worth in assets acceptable to GNMA. Rather than listing the assets that are acceptable and thus limiting them, the Guide lists exclusions. The Guide states, "acceptable assets exclude such intangibles as goodwill, copyrights, organization expenses, franchises, etc., and may exclude certain other assets of doubtful economic value as determined by GNMA."

On June 11, 1980 GNMA published regulations that require all issuers of GNMA guaranteed mortgage-backed securities to mark certain forward contracts to market and to post maintenance margin deposits in one of the following forms: cash, unmatured, negotiable debt obligations issued or guaranteed by the U.S. government or agency thereof and irrevocable, unconditional letters of credit with an independent financial institution. They also require issuers to use mark-to-market accounting procedures. Both parties must mark-to-market at

least once a week from the trade date until settlement date. The regulations also include a "suitability rule" to help assure that issuers engage in forward transactions in a manner that does not impair their capital or their ability to service outstanding GNMA securities.

The proposed maintenance margin requirement runs both ways and restricts issuers to transacting forward contracts with dealers and investors that are willing to post maintenance margin deposits weekly in cash (or any of the other acceptable forms listed above). The required margin payments must be 100 percent of any unrealized loss on the difference between the current market price and the contract price. The requirement applies, with certain exceptions, to all forward purchases of GNMA securities by an issuer (as well as those to be obtained under repurchase agreements and standbys) with delivery scheduled more than 30 days after the contract date. One exception, however, is particularly important. The proposed margin requirement does not apply to the issuer/seller if he is acting in the normal course of GNMA production, i.e. a 150-day production cycle. The GNMA issuer will, however, still be required to obtain margin maintenance from the securities dealer or investor on the other side of the forward contract.

The regulation also requires GNMA issuers to post maintenance margin deposits with respect to forward contracts that involve forward purchases of GNMA securities which are to be "paired off" against forward contracts to sell GNMAs, if the GNMA issuer's production of mortgages proves insufficient in size to cover forward sales contracts on a delivery date. This also applies to cases where an issuer purchases GNMAs forward to deliver against a standby commitment

under which the mortgage banker has the option to deliver. These "pair off" and standby transactions are not uncommon in a time of rising interest rates and waning demand for mortgages.

The above regulations, excluding mark-to-market requirements, are effective July 14, 1980. The mark-to-market provisions become effective September 11, 1980.

State Regulatory Actions

Two possible general approaches are evident in state regulation applicable to the markets for government-related securities. First, some state securities, or "blue sky," commissions regulate dealer activity in government-guaranteed securities either by imposing upon dealers in those securities the same regulatory system applicable to other securities dealers, or by adopting specific provisions that are designed to address problems peculiar to government-guaranteed securities dealers. Such state regulation of dealers is generally modeled after federal regulation, although it varies in scope and stringency. Second, some states impose limits on the extent to which certain classes of investors subject to regulation may purchase government-related securities. It appears that few of the state agencies charged with the regulation of such investors, e.g., state insurance departments or departments of banking, have taken specific actions to prevent abuses in the the government-guaranteed securities market. 3/

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3/ An appendix is attached that contains a survey of the regulatory responses of seven states to developments in the government-guaranteed securities markets.

Industry Self-Regulatory Efforts

Mortgage-backed securities dealers organized during the first half of 1978 to lead the securities industry in efforts to develop an industry self-regulatory program with respect to trading in GNMA securities. The GNMA Mortgage-Backed Securities Dealers Association (founded in 1972) developed a proposal to create a self-regulatory organization, the Mortgage-Backed Dealers Association (now the Mortgage-Backed Securities Association ("MBSA")), for banks, securities firms, and mortgage bankers dealing in mortgage-backed securities. 4/ The MBSA was intended to adopt rules and regulations to establish (1) standards of ethical conduct and fair practice, (2) uniform industry practice with respect to delivery, clearance, and processing of trades, (3) recordkeeping and financial responsibility procedures, and (4) codes of arbitration and member discipline. In October 1978, the MBSA submitted its draft articles of incorporation, bylaws, and rules and regulations to the Department of Justice for review under its business review procedure. 5/

In addition to the efforts of the MBSA to create a self-regulatory organization during 1978, the Public Securities Association (a national trade

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4/ In July 1978, the members of the GNMA Mortgage-Backed Securities Dealers Association approved, in principle, a proposal to establish the MBSA. At that time, the Public Securities Association (the "PSA") indicated its support for the MBSA proposal. The Government Guaranteed Loan Dealers Association prior to its merger with the PSA, had also considered the adoption of a code of conduct for its members.

5/ A "business review" request is a request for an expression of enforcement intention. The Department evaluates such requests only with respect to the application of the Sherman and Clayton Acts. In responding to a business review request, the Department will either indicate that it would not take antitrust action, or decline to so state. The Department may review its decision if the original circumstances change. See 28 CFR §50.6.

association established in 1977 to represent broker-dealers and banks that underwrite, trade, and sell municipal, United States government, and Federal agency securities) examined the need for and the feasibility of establishing an industry self-regulatory mechanism for mortgage-backed securities dealers, and, to the extent necessary, dealers in other exempted securities. In October 1978, PSA's board of directors authorized its staff to organize an independent non-profit corporation, affiliated with PSA but with its own separate membership, governing body, and rules, as a self-regulatory body for brokers and dealers in government and Federal agency securities. The MBSA encouraged its members to support the efforts of the PSA in this effort. 6/

In January 1979, PSA held informational meetings, attended by representatives of several interested federal regulatory agencies and by members of the securities industry, in which the elements of a proposed industry-sponsored self-regulatory body, PSA Governments, Inc., were described. PSA indicated that the essential task of PSA Governments, Inc. would be to develop standards of conduct for members effecting transactions in GNMA securities, and to consider substantive rulemaking in several areas, including those identified in the

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6/ In August 1979, the MBSA and PSA Self-Regulation, Inc. (PSA-SRI) issued a joint statement designating PSA-SRI as the organization responsible for implementing a self-regulatory system for dealers in government mortgage-backed securities. Shortly after that announcement, MBSA urged its member firms dealing in mortgage-backed securities to consider joining PSA-SRI. Currently, MBSA functions as a trade organization for the mortgage-backed securities industry, but does not engage in rulemaking. In January 1980, a proposal to merge MBSA with PSA-SRI was advanced so that the industry could speak with "one voice" on all matters of concern to it.

Shriver Report, which had recently been released. At those meetings, PSA indicated that it believed an important factor in the success of any industry-sponsored self-regulatory system would be the formal endorsement of that organization by federal agencies, including GNMA and the Treasury, and it therefore solicited comments in advance from all interested persons on the proposed rules to be developed by the new association. In May 1979, PSA announced the formation of PSA Self-Regulation, Inc. ("PSA-SRI"), an independent corporation, to adopt "rules of business conduct" applicable to brokers, dealers, and bank dealers in government mortgage-backed and government-guaranteed securities. 7/

In June 1979, the Justice Department responded to the MBSAs October 1978, business review request. 8/ In its response, the Department noted the public purpose to be served by a self-regulatory organization which might minimize the potential for abuse in the mortgage-backed securities markets, referenced the types of abuses in the GNMA market which had already come to light, and generally commented favorably on the MBSA's proposed rules and regulations "as an effort to minimize unfair and unethical practices and to make uniform

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7/ Membership in the self-regulatory organization is open to any broker, dealer, or bank engaged in the business of effecting transactions in government mortgage-backed or government-guaranteed loan securities. PSA-SRI generates its revenues from membership dues. PSA, the parent trade organization, currently provides staff resources and facilities to PSA-SRI.

8/ Letter to Victor S. Friedman, Esq., from Donald J. Flexner, Acting Assistant Attorney General, Antitrust Division, dated June 25, 1979 ("Flexner" letter).

trading practices in the mortgage-backed securities market." Nevertheless, because of the uniform maintenance margin provision in the proposed rules, which the Department viewed as potentially anti-competitive, the Department declined to state that it would not challenge implementation of the proposal as a violation of the Sherman Act.

Specifically, the proposed MBSA rules relating to uniform industry practice contained provisions which would establish uniform maintenance margin procedures for members entering into contracts for the sale of mortgage-backed securities calling for settlement more than four months after the contract date. In discussing the draft provision, the Department stated that an agreement to impose uniform margin requirements on all parties to a contract for sale, regardless of individual consideration of "credit worthiness and credit needs," might raise antitrust problems, since such an agreement would eliminate the ability of association members to compete for customers by foregoing margin or setting lower margin requirements. 9/ The Department stated that a "uniform and agreed-upon market maintenance requirement does not appear essential" to achieve either the general objectives of the MBSA, or to achieve the more specific goals of making customers aware of the "speculative nature" of delayed delivery contracts and ensuring that parties are able to perform their obligations under such contracts.

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9/ Flexner letter, at 4.

In early July 1979, PSA-SRI solicited comment on its initial proposed rules from members of the public, the securities industry, and several interested federal agencies, including the SEC, the Treasury, and the FRB. The proposed rules of PSA-SRI, to a great extent, incorporated the self-regulatory proposal of the MBSA, and, accordingly, the general areas of substantive rulemaking by the two industry-sponsored groups are similar in scope and purpose. The PSA-SRI proposed rules relating to transactions in mortgage-backed securities, like those of the MBSA, included a series of definitional rules; recordkeeping requirements; uniform standards for processing, clearance, and settlement of transactions; a code of fair practice which included suitability and supervision guidelines; financial responsibility procedures; and codes of of arbitration and member discipline. Because of the Justice Department's position, expressed in its business review letter, with respect to the antitrust implications of the MBSA's uniform margin requirements, the PSA-SRI's proposed rule concerning financial responsibility did not impose uniform margin and "mark-to-market" requirements, but instead provided margin-related guidelines for members. 10/

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10/ The PSA-SRI rule would have required a member to adopt and maintain "written procedures for determining the risk limits it will extend and lengths of settlement it will permit on various types of transactions involving mortgage-backed securities for any customer or dealer" (Art. IV, Rule 401). In the event a member determined not to obtain margin from a customer in an amount at least equal to any adverse change in market value with respect to delayed-delivery or stand-by contracts, the member would be required to designate an officer to review such determination weekly (Art. IV, Rule 402).

The Treasury coordinated an interagency response to the initial PSA-SRI proposal. 11/ The SEC staff conveyed its comments by letter. 12/ Both groups of commentators identified similar concerns with respect to the proposed rules, including the desirability of uniform margin provisions and the need for a more detailed suitability rule. The SEC also emphasized the importance of specific professional qualification requirements and strengthened supervisory procedures.

Shortly after receiving comments from interested federal agencies on the proposal, PSA-SRI circulated revised proposed rules which reflected certain recommendations of those agencies. PSA-SRI determined, however, that it could not propose mandatory margin requirements until potential antitrust problems could be resolved.

PSA-SRI adopted rules relating to transactions in mortgage-backed securities on January 1, 1980. 13/ The rules establish requirements govern-

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11/ An interagency response to the proposed rules was communicated to representatives of PSA-SRI at a meeting on September 17, 1979. The response represented the views of the staffs of the Treasury, GNMA, Comptroller of the Currency, the FRB, and FHLMC. PSA-SRI did not submit its proposed rules to the Justice Department for review.

12/ Letter to Roger Klein, Executive Director, PSA, from Douglas Scarff, Associate Director, Division of Market Regulation, dated September 14, 1979.

13/ The term "mortgage-backed security" is defined in Art. I, Rule 103.16 to mean "all participation interests in pools of mortgage loans issued or guaranteed by instrumentalities of the United States government, including without limitation, pass-through and modified pass-through certificates guaranteed by GNMA and Mortgage Participation Certificates and Guaranteed Mortgage Certificates issued by FHLMC. The term shall also include all commitments or arrangements to purchase or sell such securities including repurchase agreements, reverse repurchase agreements, and stand-by contracts but excludes all contracts for future delivery and options on mortgage-backed securities executed on a contract market."

ing transactions in mortgage-backed securities between members of PSA-SRI or between a member and a customer or person who is not a member. The rules, substantially similar to the proposed rules described earlier, include general principles and definitions, operations and recordkeeping requirements, a code of fair practice which contains suitability and supervisory procedures, financial responsibility requirements in the form of margin-related guidelines for members, and an arbitration code. 14/

PSA-SRI's effort to organize quickly an effective self-regulatory organization for dealers in mortgage-backed securities has encountered a number of difficulties. One of the most serious problems in attracting full industry support for PSA-SRI 15/ appears to be the limitations under the anti-trust laws on PSA-SRI's ability to draft uniform margin rules. The rules adopted by PSA-SRI encourage individual firms to establish their own prudent constraints on risk by, among other things, evaluating the need for margin requirements on a customer-by-customer basis and by designating an officer to review certain credit determinations on a weekly basis. Because the rules do

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14/ Although the membership has approved the rules package in principle, certain important rules will become effective at an unspecified future date, including those concerning supervisory procedures, a uniform disclosure of risk statement (Art. III, Rules 307 and 308), and a code of arbitration (Art. V, Rule 501). In addition, a disciplinary proceedings code which would establish procedures for handling complaints against members has not yet been developed.

15/ Of the approximately 60-80 active dealers in government-guaranteed mortgage-backed securities, 31 have joined PSA-SRI to date. MBSA, the industry trade group, has approximately 40 members, 25% of which are active dealers, with the remainder consisting of mortgage bankers and other market participants.

not impose uniform margin or mark-to-market requirements, it appears that certain industry participants may believe that PSA-SRI's self-regulatory efforts are not sufficient to deal with problems in the forward markets that result from an absence of controls designed (1) to decrease speculation by limiting the leverage available to customers and (2) to reduce the risks associated with forward trading by enabling market participants to monitor their potential gains and losses. 16/ In addition to difficulties concerning uniform margin requirements, other antitrust considerations have hindered PSA-SRI's efforts. In commenting on the earlier MBSA proposed rules, the Justice Department expressed concern that several rules (including those relating to member disciplinary proceedings) when read together "could be construed as prohibiting members from dealing with non-members who fail to follow the Association's standard of conduct." Any provisions encouraging a "refusal to deal" by members with non-members would be inconsistent with the antitrust laws. In order to avoid such criticism, PSA-SRI is a voluntary membership organization which intends to develop a disciplinary code separate from its rules.

Without an effective system to enforce industry-wide adherence to certain standards of ethical conduct, such as suitability and disclosure of risk procedures, it is uncertain whether PSA-SRI can reduce sufficiently

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16/ PSA-SRI has stated that "[i]n our view, it is unfortunate that the implications of the antitrust laws have precluded any industry attempt to achieve financial responsibility of market participants through a uniform market maintenance requirement." Letter to the Hon. Paul A. Volcker, Chairman, FRB, from Roger D. Shay, Chairman, PSA-SRI (Jan. 21, 1980).

certain types of serious problems including abusive sales practices, which have arisen in the GNMA market. In addition, the lack of uniform margin requirements, which several regulatory agencies as well as certain industry members agree would be essential to effective self-regulation, has seriously reduced PSA-SRI's ability to deal with problems related to overspeculation and credit risk in the forward market for government-guaranteed mortgage-backed securities.

Recently, PSA-SRI has directed its attention toward developing a federal legislative proposal to deal with abuses in the government securities markets. PSA-SRI has indicated that it favors federal involvement only to the extent necessary to address abuses in the mortgage-backed securities markets.

# APPENDIX

## STATE REGULATORY ACTIONS

The following pages provide a brief survey of the regulatory responses of seven states to developments in the government-related securities markets. It is based on discussions with state personnel and other available information concerning state regulatory activities. The states, Arkansas, California, Florida, Illinois, New York, Tennessee, and Texas, were selected because prior contacts indicated that certain of them had adopted or were considering special regulations concerning the government-related securities market, contact had already been established with certain of their officials, or their size suggested that problems associated with the market might exist and that there might be an awareness of and reaction to those problems. For this reason, the regulatory pattern in these states may be atypical and, more extensive and detailed than in other states.

### "Blue Sky" Laws and Dealer Regulation

Government-related securities are themselves exempt from "blue sky" registration in each of the seven states surveyed. Nevertheless, except in those states in which government-related securities dealers may be excluded from the definition of "broker-dealer" or "dealer", 1/ even dealers participating exclusively in sales of government-related securities must register as dealers and comply with pertinent state regulations. Enforcement of such requirements depends upon the resources and policies of the blue sky commission involved.

In general, the states surveyed have enacted laws or relevant state agencies had adopted regulations that were modeled, although usually in a partial and fragmentary manner, after SEC regulations. For example, most of the states surveyed have adopted net capital and recordkeeping requirements. States, however, do not appear to have adopted general explicit suitability requirements of the sort adopted by self-regulating organizations (SROs).

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1/ California law excludes banks, trust companies and loan associations from its definition of "broker-dealers." The Florida statute excludes properly state-authorized banks, trust companies and "wholesalers" from its definition of "dealer." New York excludes persons selling solely to any bank, corporation, savings institution, trust company, insurance company, investment company (registered under the Investment Company Act of 1940), pension or profit-sharing trust or "other financial institution or institutional buyer" from its definition of "dealer." In addition, Texas excludes dealers selling exclusively to institutions, such as savings and loans, banks, and insurance companies.

Arkansas, Florida, and Tennessee have each adopted some regulations applicable to government-guaranteed securities dealers. Florida recodified its blue sky regulations during 1979 and adopted only one provision covering government-guaranteed securities dealers; that provision allows those dealers to maintain a minimum net capital of $25,000, rather than the amount of capital that would be required by the SEC's capital rule. Tennessee imposes a higher minimum net capital requirement upon dealers who trade exclusively in government-related securities than upon other dealers. Arkansas imposes extensive net capital requirements on all dealers, but treats GNMAs favorably, by including forward commitments to purchase such securities in the calculation of aggregate indebtedness only under certain conditions. In addition, Arkansas deems adjusted trading, excessive markups, and interpositioning to be unfair, misleading, and unethical practices and, as such, grounds for suspension or revocation of the registration of a broker-dealer or its agent.

## Regulations of Investors

Statutes in every jurisdication surveyed deem government-guaranteed securities to be permissible investments under state fiduciary law. The commonly regulated institutions likely to be participants in the markets for regulated institutions likely to be participants in the markets for government-related securities include commercial banks, thrift institutions, insurance companies, and credit unions. The response of the various state agencies having jurisdication over such institutions to conditions in government-related securities markets has varied.

## Banks and Thrift Institutions

Generally, state regulators do not impose any limitations on commercial bank investments in government-guaranteed securities. The regulators of banks and thrift institutions in the states surveyed apparently have considered rulemaking unnecessary, in part because institutions whose deposits are insured by federal agencies are bound by those agencies' guidelines with respect to trading in government-related securities. It also appears that some state regulators are inclined to follow and enforce guidelines promulgated by federal regulators, such as the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation ("FDIC"). For example, one official indicated that, although no formal rulemaking had occurred in his state, if the question of investing by thrift institutions in forwards and other speculative instruments arose, the state would probably respond by following the guidelines and policies of the FDIC and the Federal Home Loan Bank Board (FHLBB).

Some other state regulators have taken more specific actions. The New York Banking Department has issued a letter to banks under its jurisdiction warning those institutions about the speculative nature of forward trading in securities, particularly GNMAs and enumerating some drawbacks to such investments. In the letter the Superintendent of the Department recommended banks engaging in forward trading institute a regular internal reporting system so that the banks' officials are fully informed of the institutions' commitments. The Tennessee State Banking Commission has proposed a rule that would prohibit all bank trading in forwards by deeming such trading to be an "unsafe and unsound" practice, and an official of that state's Insurance Department indicated that it intends to adopt rules modeled after those promulgated by the FHLBB. The Arkansas State Bank Department has issued warnings to state banks declaring that trading in mortgage futures on a speculative basis is an unsafe and unsound banking practice. In addition, the Arkansas Securities Department has issued a letter notifying thrift institutions that speculation in government-related securities, including futures, forwards, standbys, and reverse repos, would be considered "unsafe and unsound." The Texas Banking Commission has adopted no rules or regulations limiting commercial bank participation in the government-guaranteed securities markets. We understand, however, that it has rendered advice on an ad hoc basis to banks in its jurisdiction that were experiencing problems. A similar course of action has been followed with regard to thrift institutions. The Texas Savings and Loan Department indicated that it generally had endorsed FHLBB rules and guidelines to deter speculation in standbys by thrift institutions.

## Credit Unions

State regulators of state-chartered credit unions also recognized the the problems that have arisen in trading of government-related securities. The Illinois Department of Financial Institutions has proposed a rule that would prohibit credit unions from selling securities short, trading on margin, investing in futures and forwards, and participating in adjusted trades. Another state agency anticipates that it will adopt regulations modeled after those of the National Credit Union Administration. Two state agencies have have issued letters regarding speculative trading. The Arkansas Securities Commission issued a letter to credit unions under its administration declaring speculation in government-guaranteed securities, including futures, forwards, standbys, and reverse repos, to be an "unsafe and unsound" practice, while the Texas Credit Union Department has admonished its credit unions, in light of heavy losses experienced by two Texas credit unions in GNMA forwards, to avoid speculative forward trading.

Although two states, Tennessee and Texas, indicated that credit unions there have experienced difficulties in the GNMA market, the consensus among other state officials surveyed was that preventive activities appear to

be sufficient, since credit unions under their regulation lacked sufficient capital to consider speculating in the government-guaranteed securities markets or were aware of abuses because of NCUA rules and guidelines.

## Insurance Companies

None of the state insurance regulators surveyed has adopted any regulations specifically tailored to curb abuses in government-related securities. Nevertheless, agencies in two states, California and Florida, have barred investments in futures and forwards through interpretation of existing statutes. In those states the law requires the assets of an insurance company to be held in the company's account and any interest or dividends on such assets must be to the exclusive benefit of the insurance company. Since physical delivery of the instruments underlying futures and forwards is delayed for a substantial period after a trade, California and Florida prohibit these investments.

# CHAPTER VI

## FEDERAL REGULATION OF BROKERS AND DEALERS IN GOVERNMENT RELATED SECURITIES: ANALYSIS, CONCLUSIONS AND RECOMMENDATIONS

This chapter addresses a variety of considerations bearing on whether federal regulation should be extended to dealers in government guaranteed and other related securities and, if so, what specific kinds of regulation are needed. In particular, it first reviews estimates of the losses suffered by investors, primarily in exempted mortgage-backed securities, in cases where abusive trading practices were present. The need for and potential costs of regulation of dealers designed to prevent similar problems in the future are then considered in light of the measures recently adopted by GNMA and financial institution regulatory agencies. Based on the conclusion that additional regulation of the market for mortgage-backed securities is needed, the discussion then turns to an examination of (1) the role and implementation of margin rules and whether they would by themselves be a sufficient form of regulation, and (2) what other types of regulatory measures may be appropriate.

The discussion concludes that the problems inherent in forward trading of GNMA and FHLMC mortgage-backed securities warrant creation of a flexible regulatory system for dealers engaged in forward trading in these securities. Such trading is presently exempt from most of the federal securities laws. The system proposed has been designed to permit extension of regulation to other sectors of the government guaranteed and related securities markets. The participants in the study have concluded that at this time the extension of regulation to markets for other government related securities is unnecessary and not warranted by the evidence.

Estimates of Investment Losses and Regulatory Costs

In deciding whether federal regulation of brokers and dealers should be extended, it is appropriate to attempt an assessment of the losses that have been incurred by market participants in cases where abusive practices were present and to compare those losses with the costs that would be incurred if a regulatory framework were established to address these abuses. The available information permits only rough estimates of the measurable costs and potential benefits of regulation.

With regard to losses, it should be noted that the cases reviewed in the Appendix to Chapter IV are only those that have been investigated by the SEC. There have been other complaints filed that have not been included because sufficient information is not available. Moreover, these cases do not reflect fully the losses that have been recorded by many other financial institutions, nor do they include several other cases that have recently been given coverage in the national press. On the other side, a simple addition of losses in cases where abusive practices were present may overstate such losses. In five of the cases in the Appendix, there has been at least a partial payback of initial losses by the dealers or other parties involved. Further, a large share of the losses in certain cases is attributable to a combination of overextended positions and rapid changes in interest rates, which have fluctuated sharply in recent years. If interest rates had remained stable or moved in the opposite direction, the ultimate financial effects on the investors in many of these cases might have been quite different.

Similar uncertainties also impede an accurate assessment of the potential costs of regulation. The study staff was unable to assess the potential indirect costs of regulation, nor was it able to determine the precise costs to dealers of compliance with possible regulatory requirements. Also, regulatory costs would depend, to some degree, on the number of market sectors to be brought under the mantle of regulation and the kind of regulation that is introduced.

Despite the above mentioned problems, presenting the available estimates of losses and measurable regulatory costs serves a purpose. The Appendix to this Chapter contains a discussion of the losses in cases where abusive practices were a factor and presents available information on some of the measurable costs of regulation in the municipal securities market, the most closely analogous market. However, the study participants are not basing their conclusion that regulation of this market is needed or appropriate on a mechanical evaluation of monetary cost/benefit data. Indeed, the imprecise and incomplete nature of much of the data does not justify placing much reliance on such data in making a decision.

Instead, the study participants believe that the case for regulation is justified on broader grounds. In particular, because of the programs of government agencies and sponsored agencies involved in these markets, the study participants believe that maintenance of the efficiency and integrity of the markets for these agencies' securities is a decisive benefit, even if regulation could not be justified on a strict comparison of the monetary cost of regulation with the reduction of direct monetary loss to participants. The number and continuing nature of problems which have occurred in the forward

markets for mortgage-backed securities seem sufficient to justify such regulation.

Recent Changes in the Regulatory Context

The assessment of losses contained in this study is based on past experience with trading abuses. Recent changes in the market context may have reduced the potential for abusive practices and problems. While a disturbing number of problems in the GNMA market have recently been reported in the press, many of these problems result from transactions which occurred in late 1978 or earlier, and there may be less likelihood that investors will become so involved in the future. There is greater awareness now of the high risks involved in forward trading, a point which the recent sharp fluctuation in the prices of fixed income securities has dramatically reinforced. Thus, investors and issuers may now be somewhat less susceptible to the blandishments of unscrupulous salesmen than in the past. 1/ Greater care, spawned by past abuses, may also characterize the operations of dealer firms that might be tempted to engage in unsound practices. 2/ In many of the major cases in which dealers engaged in abusive practices, they also ended up suffering serious financial losses. As a result, dealers may have become more wary of doing business with the potentially irresponsible investor who might walk away from an unfavorable commitment.

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1/ It might be noted, however, that while investors that trade in these securities on a continuing basis gain a first-hand appreciation of the risks such trading can entail, sporadic or one-time investors may be less likely to have gained such knowledge.

2/ In some cases in which abusive practices were a factor in investor losses, the investor may have contributed to the abusive practices by misleading dealers as to its financial position.

It should also be clear from Chapter V's discussion of the various actions taken by federal agencies that the institutions regulated by these agencies are now more constrained in their trading of these securities than they were in the past. These new rules and regulations do not, of course, ensure that further abuses will not arise, since no system of regulation can eliminate all abuses. However, it seems likely that these actions have reduced the likelihood that these regulated institutions will engage in speculative transactions of the type that can lead to large losses if the market moves adversely.

Despite these hopeful signs, the potential for losses still appears to be unacceptably large. For example, individuals have become more active in certain sectors of the government related securities markets in recent years. They, as well as some classes of institutional investors, are not subject to the guidance and protection of the recent regulations promulgated by various financial institution regulators and discussed in Chapter V.

More importantly, many of the conditions responsible for the problems in the forward markets for government related securities continue to exist. For example, it remains possible to assume large positions in GNMA securities with long delayed delivery dates without being required to provide either initial margin or maintenance margin when the market moves against that position. Some dealer firms have voluntarily imposed margin requirements on their customers, but many firms have not established any such requirements. Moreover, given the Justice Department's ruling inhibiting proposals to establish standard margin requirements without government sanction, it is clear that voluntary

efforts by individual firms in the industry are bound to be quite disparate in stringency. Thus it is likely that many firms, including those most inclined to "cut corners" and otherwise employ less than sound and suitable practices, might impose lax and ineffective requirements, if they impose any at all. Also, given the competitive disadvantages that may accrue to firms adopting stringent margin standards, it is possible that many reputable dealers might decide to impose looser standards.

In addition, dealers in government related securities are not subject to the "fair practice" rules, financial responsibility rules, and recordkeeping and qualification requirements that are applicable to other types of securities dealers. These rules directly address many of the types of abuses discussed in Chapter IV. Furthermore, the absence of registration requirements for these dealers makes effective enforcement of even the anti-fraud rules difficult with respect to their principals and associated persons. Finally, since many of the problems evident in trading of government related securities have originated with abusive sales practices by dealers, regulation aimed solely at investors may fail to address a sizeable portion of these problems.

While the prospects for similar abuse today are reduced from what they were when many of the problems described in Chapter IV originated, there remains a possibility that future losses could still exceed limits thought tolerable by market participants and the public at large. It is reasoning along these lines that underlies the positions expressed by GNMA, by various federal regulatory agencies, and by the major dealer associations and a number of individual dealer firms that reasonable regulatory measures should be imposed

with respect to trading in the forward market for GNMA and FHLMC mortgage-backed securities. These agencies and organizations generally believe that dealer regulation would complement the measures already taken by financial regulatory agencies, but there exists a wide range of views about the form and scope of any such regulatory system.

After extensive consideration, the participants in this study agree that, with regard to forward transactions in GNMA and FHLMC mortgage-backed securities, problems and abuses have been serious and not infrequent, and the measures taken thus far address only part of the practices responsible for these problems. Accordingly, we believe that a framework should be established for implementing appropriate regulatory measures.

In establishing a regulatory framework one must choose among a broad spectrum of possible approaches. Initially, it is necessary to decide whether the regulatory structure should be designed to deal only with the problems in forward markets for GNMA and FHLMC mortgage-backed securities or whether a structure should be established which is flexible enough to deal with any future problems in related areas in a relatively expeditious manner. One must then determine whether the system should be designed to meet only the major source of problems (the lack of initial and maintenance margins in forward transactions in GNMAs and FHLMCs) or whether a more comprehensive system should be imposed to meet other problems as well. Finally, a decision must be made as to who will establish rules and be responsible for their enforcement. One could adopt an approach relying almost exclusively on the private sector, with only minimal governmental oversight. Alternatively, one could rely exclusively on a govern-

mental agency to establish and enforce rules. An intermediate position, relying on input from the industry but with a fairly active governmental oversight role, could also be adopted. Finally, the role to be played by those agencies or organizations that already regulate other aspects of the business of participants in the market must also be considered.

In addition to considering the desirability of rules designed to eliminate unsound or unfair practices, one must also consider the appropriateness of providing for the adoption of rules designed to improve the functioning of the market. Proposals calling for uniform market practices and encouraging the establishment of clearing facilities are designed primarily to mandate more efficient operation of the market and are only indirectly related to the prevention of abuses or unsound practices.

Types of Securities Needing Regulation

Regulation of trading in currently exempted securities appears necessary at this time only in the case of forward trading in GNMA and FHLMC mortgage-backed securities. The study participants do not believe that the evidence of past abuses compiled in the study demonstrates a present need for regulation of markets for any other types of government related securities. In this regard, it should be noted that the eight cases reviewed in the Appendix to Chapter IV pertaining to these other types of government related securities essentially exhaust the instances of trading abuses in these instruments known by any of the agencies in this study group, a generalization that holds not only for the past five years but also for preceding years. Losses in these cases were much smaller than the corresponding losses in GNMA guaranteed mortgage-backed secu-

rities alone, and the frequency of abuses in relation to trading volume was much lower in some of these securities, particularly Treasury securities, than in GNMA securities.

The much smaller incidence of trading abuses by dealers and investors in markets for other types of government related securities stems mainly from the fact that trading for long forward delivery rarely occurs in the markets for these other securities; there is, accordingly, less opportunity for over-extension and less risk of default by the other party to the transaction. 3/ For example, transactions in outstanding Treasury securities are almost all on a same-day or next-day delivery basis; when-issued trading may take place for about two weeks. The Treasury bans all pre-auction trading in Treasury coupon securities by market participants who bid in the Treasury auction of the underlying security. It should also be noted that the great preponderance of trading in Treasury securities is done by primary dealers that are subject to surveillance by the Treasury and Federal Reserve.

While the cases involving abuses in other markets have been few and the losses incurred in these cases relatively small, the study participants believe that it may be appropriate to establish a regulatory system which, after careful consideration of the impact of regulation, could be extended administratively to cover additional markets. This may be of special

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3/ In the area of repurchase agreements, which are utilized in connection with some of these other securities, some dealers have apparently recently implemented more careful standards and procedures and thus may be more alert to avoiding problems such as failing to obtain collateral before funds are transferred. In addition, repurchase transactions are not, in themselves, inherently leveraged or speculative in character.

importance if there are any significant increases in the volume of sales of particular government guaranteed securities in the market. Such a system could respond swiftly in the event that abusive practices begin to occur in those markets which have heretofore been nearly free of abuse. Also, the potential for a quick regulatory response may in itself be sufficient to deter abuses.

Accordingly, while the participants in this study recommend a system of regulation in the forward market for mortgage-backed securities, it would be appropriate to provide an administrative mechanism which permits extending at least some regulatory measures to the cash market for GNMA and FHLMC mortgage-backed securities 4/ as well as to markets for other government related securities other than Treasury securities if the incidence of problems and abuses increased substantially in these other areas.

What Kind of Regulation is Needed?

Assuming that any regulatory scheme is limited to the appropriate types of securities, the next question is what types of regulatory measures are needed: i.e., whether the full range of possible regulatory measures discussed in Chapter IV is needed or whether more limited measures would provide sufficient protection to market participants. In particular, it seems worthwhile to explore whether expanded federal involvement should be limited to establishing and overseeing the imposition of margin requirements for forward trading in mortgage-backed securities.

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4/ In some cases, effective regulation of forward trading may require regulation of cash transactions of dealers engaged in forward trading.

A review of cases discussed in Chapter IV makes clear that most instances of large losses have occurred because investors assumed unsuitably large forward positions and failed to close out these positions quickly as losses increased. Thus, the most important regulatory objective should be to discourage the assumption of overcommitted positions, ensure that losses suffered in connection with forward positions are promptly recognized by the investors and dealers involved, and establish procedures to protect customers, dealers, and other market participants from losses occasioned by defaults.

As discussed in Chapter IV, well chosen margin requirements would largely achieve this regulatory objective, and their imposition already has wide support in the industry. 5/ They would protect forward market participants against losses that can result from other parties' defaults on forward contracts. They would also discourage over-commitments, bring incipient losses forcefully and promptly to investors' attention, and lend added financial stability to dealers and to the markets. At the same time, however, the discussion in Chapter IV recognizes that regulatory imposition of margin requirements for government related securities raises significant technical questions. These questions include: what types of securities, traders, and transactions should be subject to the margin rules; what body should be charged with formulating the margin rules; the role of initial versus maintenance margins in the system; the manner in which margin payments should be made and held; and what reduction, if any, of margin payment obligations

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5/ See page 103, *supra*.

should be recognized in connection with commitments that are hedged or off-set by other commitments. 6/

While these technical questions are formidable, the participants in this study believe that the need for mandatory margin requirements for forward transactions in GNMA and FHLMC mortgage-backed securities is sufficiently compelling to mandate their development by an appropriate combination of industry self-regulation, public participation, and regulatory oversight. With respect to the body which should establish the rules, we note that the primary purposes of margin rules in the forward market would be regulatory rather than economic--i.e., to reduce the likelihood of over-commitments and defaults, rather than to regulate the use of credit in the economy. Accordingly, the primary responsibility for setting these rules should be left to an appropriate self-regulatory organization subject to governmental oversight, with residual powers to set margins also granted to some other governmental body. We believe that the other technical questions and details concerning the margin requirements could also best be resolved in a similar manner.

In this connection, we have given special consideration to whether legislation establishing a regulatory system should also establish mechanisms such as clearing agencies to facilitate implementation and enforcement of margin requirements. Such mechanisms might provide substantial regulatory advantages, both in terms of effective enforcement of the requirements and in reducing the cost and inconvenience market participants might encounter in complying with with them. For example, in addition to facilitating efficient settlement of

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6/ *Id.*

trades, a clearing agency might implement margin rules by (1) notifying its participants (presumably mostly securities dealers) of their margin payment obligations on a daily basis, (2) monitoring their compliance with those obligations, (3) acting as a third-party escrow agent to hold the deposits, and (4) taking into account a participant's hedged or off-setting commitments to the extent that these might reduce the participant's required margin payments. Depending on its structure and powers, a clearing agency might also perform a market monitoring function, gathering information on market activity and perhaps identifying instances of overcommitments.

After extensive review, we believe that the major advantages of clearing agencies can be realized through voluntary use of these mechanisms, without legislatively mandating their creation or use. That is, appropriate participation in a clearing agency could be an acceptable method for a dealer or other market participant to comply with margin requirements, but dealers would not be required to belong to a clearing agency or process any class of transactions through a clearing agency. This voluntary approach has the advantage of allowing market forces and voluntary industry action to determine what transactions can be economically processed through a clearing agency. At the same time, however, we believe that provision should be made for registration and appropriate oversight of any such agencies that may be formed in order to assure that they operate fairly, efficiently, and safely, and that they produce the regulatory benefits that can reasonably be expected of them. 7/

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7/ After experience with the operation of clearing agencies for government related securities in the context of regulation in that area, it might be appropriate to encourage, or even require, inclusion of particular types of transactions in some type of central clearing or information processing system.

Since margin requirements would achieve a primary regulatory objective, one must consider whether they would constitute a sufficient regulatory system in themselves or whether provision should be made for the possible application of other regulatory measures to the trading of government related mortgage-backed securities. The study participants have concluded that other measures are required, but believe that the determination of the specific measures to be adopted may best be left to a self-regulatory organization or oversight body after appropriate inquiry into industry conditions. The cases reviewed in Chapter IV reveal a number of problems which it might be desirable to address by other regulatory measures. These measures can be grouped into five categories: (1) "fair practice" rules (including suitability, disclosure, and other requirements); (2) competency and qualification requirements; (3) financial responsibility rules; (4) registration, recordkeeping and reporting requirements; and (5) disciplinary and enforcement mechanisms.

Based on the information in Chapter IV, we believe that some of the regulatory measures discussed there may be appropriate, in addition to margin requirements, for application at this time to GNMA and FHLMC mortgage-backed securities. In this regard, cost and enforcement-oriented considerations are pertinent. Effective implementation and enforcement of margin requirements for forward trades might require dealer registration, implementation of mandatory recordkeeping provisions for dealers, and a program of dealer surveillance and inspections. Assuming the existence of such a system, which might rely on existing federal agencies and SROs, the incremental cost of devising and enforcing additional regulatory measures, such as those described in Chapter IV, should be manageable.

Many of the regulatory measures discussed in Chapter IV can be justified as good business practices for broker-dealers. If measures have already been adopted by significant parts of the industry, they should, of course, be given priority consideration in the formulation of any system of broker-dealer regulation for forward transactions in GNMA and FHLMC mortgage-backed securities. Rather than imposing any of these rules legislatively, however, we think it generally preferable to allow a self-regulatory organization and oversight body to make the initial determination of the benefits and burdens of possible rules in these areas. Accordingly, we believe that the regulatory structure should include a self-regulatory organization subject to governmental oversight, and, further, that this organization, the oversight body, and, where appropriate, existing administrative agencies, should be given the authority to establish regulatory requirements not only with respect to margins but also in the other areas discussed in Chapter IV. This approach would allow adoption of a range of regulatory measures that could minimize, to the extent possible, the range of abuses experienced thus far; at the same time, it would allocate most responsibility for judgments of the advantages and disadvantages of potential regulatory measures to knowledgeable personnel who would have the advantage of appropriate industry input.

Recommended Regulatory Structure

After extensive consideration of possible regulatory structures, we have concluded that a desirable framework would use as a model the system currently in place for the municipal securities markets, but with several significant modifications. This system appears to be a relevant model since there

seem to be certain structural similarities between the two segments of the industry. 8/ In addition, the system was recently created but has now been in operation for several years, and its use as a model may involve certain efficiencies. The principal differences between the proposed system for government related securities and the existing system for municipal securities reflect the inherent differences between forward markets and cash markets, as well as the interest of the federal government in the markets for government related securities and the role of many of those securities as instruments of national monetary policy.

As detailed below, the primary rulemaking authority for government related securities trading should be allocated to a new rulemaking board (the "Board") composed primarily of industry representatives. We believe that the name which would be most descriptive of the activities of the Board would be the Federal Mortgage-Backed Securities Rulemaking Board. However, if trading in other government related securities which are not mortgage-backed securities were brought within the regulatory authority of the Board, it might be appropriate at some future date to change the name of the Board to reflect any change in the scope of its rulemaking authority.

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8/ One of the most important similarities is the presence of entities already subject to a regulatory structure in both markets. When the regulatory system for the municipal securities markets was established, concern with the possible impact of imposing an additional inspection and enforcement structure on banks and registered broker-dealers was an important factor in the decision to make use of established structures to perform these functions. Other similarities are the importance of institutional investors, the predominance of dealer rather than agency markets, and the absence of a transaction reporting system.

Because of differences between dealers which are securities firms and dealers which are banks, it seems appropriate that each group be represented. Consideration should also be given to including on the Board persons not associated with dealers. Such a Board would be a self-regulatory organization ("SRO"), and like existing SRO's would exercise its rulemaking authority subject to oversight by a governmental body. The study participants believe that, in view of the broad responsibilities of the Board for assuring the integrity of the market for government related securities and the implications of developments in this market for securities markets in general, this oversight group should be a "Council" composed of the Secretary of the Treasury, the Chairman of the Federal Reserve Board, and the Chairman of the SEC, or their respective designees. With respect to rules for mortgage-backed securities, the views of the Secretary of HUD and of GNMA and FHLMC will be sought by the Council and given full consideration in its deliberations.

At the present time it does not appear that the Council will need a separate staff or budget. It would instead utilize the staffs of the three agencies whose representatives would serve on the Council. The proposed regulatory structure should require registration of brokers and dealers (both referred to herein as "dealers") effecting transactions in those types of government-related securities that are subject to regulation. Primary examination and enforcement authority over registered dealers should be allocated among regulatory agencies and organizations already performing similar functions with respect to bank and nonbank dealers. In addition, the proposed regulatory structure should provide for the registration and oversight of clearing agencies for government related securities.

Scope of Regulation

The proposed new system would regulate the market for forward transactions in GNMAs and FHLMCs, the class of government related securities with the most active forward trading and the area where abuses have been most evident in the past. In order to allow the regulatory system to respond to changes in trading practices, the oversight Council should be authorized to specify the transactions which will be considered forward transactions subject to regulation.

Because of the interrelationships between forward transactions and cash transactions, it might be necessary, in order to regulate the forward market effectively, to extend regulation to cover transactions in the cash market by dealers who are active in the forward market. The Board should be given authority to extend its rules to transactions in the cash market in such cases, but only if the oversight Council unanimously approves such an extension after finding that the extension to the cash market is necessary or appropriate for effective regulation of the forward market.

In order to allow the regulatory system to address new problems--or old problems in new areas--without the need for new legislation, the oversight Council should be authorized to bring additional types of government related securities within the system of regulation. 9/ (GNMAs and FHLMCs and any other government related securities that are brought within the system are hereafter

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9/ Government related securities would not include securities issued directly by the Treasury.

referred to as "designated securities.") Any extension of regulation to cover trading in additional government related securities should be made only on the unanimous vote of the Council. In addition, agencies whose activities would be affected by any proposed extension of regulation should be consulted by the Council prior to approval of any extension of regulation. 10/

The regulatory system should require all currently unregistered securities dealers that trade in designated securities to register with the Council. This function, initially, would be delegated to the SEC. Because banks currently act as dealers in these securities (as they do in municipal securities), the system should apply to bank, as well as nonbank, dealers. 11/ In order to avoid undue regulatory burdens for already registered bank dealers, any registration requirements for banks should be designed to permit them to fit together with those for municipal securities dealers, which permit registration of the whole bank, or a separately identifiable department or division of the bank, at the bank's option. 12/

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10/ As is the case with issuers of municipal securities, issuers or guarantors of government related securities would not be subject to regulation under the proposed system, although regulation of such entities by other governmental bodies could continue. For example, GNMA could continue to set requirements for the business and operations of issuers of securities guaranteed by GNMA.

11/ As in the case of municipal securities, banks that limit their activities with respect to designated securities to agency transactions would not be required to register. Dealers already subject to regulation because of their nonexempted securities activities would be deemed to be registered and subject to the new requirements applicable to their government-related securities activities.

12/ See Sections 3(a)(30) and 15B(b)(2)(H) of the 1934 Act. Accordingly, for banks able to conduct both their municipal and their government related securities business in one department, as is commonly the case, that department, rather than the entire bank, would be subject to dealer registration.

Rulemaking Responsibilities

The Board should have primary rulemaking authority over dealers in designated securities. It should not be a voluntary membership entity; all such dealers should be subject to its rules. In order to increase industry involvement in the organization and to facilitate use of "businessman's judgment" in developing standards, 13/ the Board should be composed primarily of representatives of bank and nonbank dealers.

The Board should be given both specific and general rulemaking power. One area of specific rulemaking authority which the study participants believe is essential is the formulation and imposition of margin requirements for transactions in designated securities. 14/ This rulemaking authority, like other rulemaking authority of the Board, would be subject to approval by the Council. In order to permit prompt governmental response to serious speculative problems in the market, the Council should be given emergency power to impose or change margin requirements on an expedited basis.

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13/ See., e.g., Report of the Sen. Comm. on Banking, Housing, and Urban Affairs to Accompany S. 249, S. Rep. No. 94-75, 94th Cong., 1st Sess., 46-47 (1975). It would also be important to include representatives of persons not associated with the securities industry. So long as the major part of the Board's activities involve regulation of markets for mortgage-backed securities, including a mortgage banker on the Board would also be appropriate.

14/ We do not anticipate that the initial margin requirements for forward contracts would even approach the 50% range of the margin requirements for present purchases of stock. Indeed, they might be as small as a few percent. However, the study participants believe the Board should consult with the Federal Reserve Board to ensure that it concurs in any changes in margin requirements. In any event, we recommend that the Federal Reserve Board be given the power to set its own margin requirements, which, if exercised, would supersede the Board's or other applicable margin requirements.

The Board should also be given rulemaking authority with respect to fair practice standards (including rules pertaining to prevention of fraudulent and manipulative acts and practices and to suitability, supervision, and customer confirmation requirements), professional qualification and competency requirements, recordkeeping, financial responsibility and uniform practice requirements. 15/ To increase regulatory efficiency and prevent unnecessary costs or burdens on securities professionals, the Board's statutory mandate should also specify that, to the extent feasible, certain of the Board's rules should be similar to those already applicable to brokers, dealers, and municipal securities dealers. For example, the Board's recordkeeping rules could be coordinated with other applicable recordkeeping requirements in order to avoid burdensome or duplicative requirements for dealers that do business in government related and other types of securities.

The Board would exercise its rulemaking authority subject to the oversight of the Council, which would evaluate Board rules. 16/ In addition to its authority to approve or disapprove Board rules, the Council should be given the power to abrogate, add to, or delete from the rules of the Board. The Council should be required to consult with GNMA and FHLMC and other agencies when markets for securities which those agencies issue or guarantee

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15/ In addition, the Board should be required to establish fair procedures concerning the election of members, and to adopt rules providing for the administration of the Board and for a fee structure applicable to government related securities professionals.

16/ Meaningful governmental oversight over an SRO's activities would appear to be necessary and sufficient to justify antitrust immunity for the SRO. See Gordon v. New York Stock Exchange, Inc., 422 U.S. 659, 685 (1975); United States v. National Association of Securities Dealers, Inc., 422 U.S. 694 (1975); Silver v. New York Stock Exchange, Inc., 373 U.S. 341 (1963).

might be affected by any proposed rule, before taking final action with respect to such rule.

The Council should also be given authority under certain provisions of the 1934 Act to make rules governing dealers trading in designated securities. This authority should include control over the dealer registration process and authority to make rules governing registration of dealers; recordkeeping; and financial responsibility. This authority should include broad emergency powers to ensure that the Council could deal swiftly and effectively with sudden developments. It is expected that the Council, in its rulemaking activity, will rely heavily on the expertise of the SEC and other agencies and, in appropriate circumstances, may delegate its rulemaking authority. In addition, the Council should be required to take into account the needs of the SEC in carrying out its enforcement responsibilities.

Other entities might also be given specific types of rulemaking authority with respect to dealers in government related securities. The SEC will retain general antifraud rulemaking authority it presently exercises over exempt securities. The SEC also would retain its present rulemaking powers with respect to integrated securities firms which trade both government related securities and corporate and/or municipal securities. The bank regulatory agencies should also retain their existing authority under banking laws to make rules governing the government related securities activities of banks in the areas of recordkeeping, reporting, financial responsibility and safe and sound banking practices. The Federal Reserve Board would be given resi-

dual margin rulemaking authority with respect to designated government related securities. Nonbank dealers should also be required to become members and subject to the requirements of the Securities Investor Protection Corporation ("SIPC"). Because SIPC's fund is now at the statutorily required level of $150 million, SIPC has reduced assessments on members to a flat fee of $25 per year. The study participants believe that, in fairness to those broker-dealers whose payments to SIPC have built up the SIPC fund, the new class of dealers required to join SIPC should be required to pay a higher fee for a period of time. SIPC has suggested that a fee of 1/4% of gross revenues for three years would be appropriate. While SIPC's existing statutory authority would permit imposing a separate assessment on the new class of members, both SIPC and the study participants believe that Congressional direction to SIPC to impose such a fee would be appropriate.

Uniform Practice Rules and Clearing

In addition to providing the Board authority to establish uniform practices and standard requirements for dealers' activities in clearing, processing, and settling transactions, the statutory provisions should provide for registration and rulemaking oversight by the Council of one or more clearing agencies for government related securities. The Council should be given authority to delegate its responsibilities over clearing agencies, and because of the SEC's expertise in this area we believe that this should be given to the SEC. The formation of, and participation in, such clearing agencies should be voluntary; as noted previously in this

Report, at least one such agency is already processing transactions in GNMA forwards. (Clearing agencies not only can facilitate the clearance and settlement processes but can also assist dealers and other market participants in complying with margin requirements. They might also perform recordkeeping and monitoring functions.) The rules of clearing agencies for government related securities, like those of other clearing agencies, should be subject to approval by the appropriate oversight agency (either the Council or an agency to which the Council has delegated its authority), which agency should also be able to abrogate, add to, or delete from the rules of the clearing agency. To allow reasonable freedom of action for such clearing agencies, the Board's uniform practice rules should be required, to the extent feasible, to foster cooperation and coordination with entities engaged in clearing, settling and facilitating transactions in government related securities.

Inspection and Enforcement

Inspection and enforcement authority for dealers in designated securities should be allocated in the same fashion as for municipal securities professionals, with additional responsibilities given to national securities exchanges. Under such an allocation, the NASD and the exchanges, the federal bank regulatory agencies, and the SEC would conduct compliance examinations and institute enforcement actions. Such a division of responsibilities would minimize costs, avoid unnecessary additional compliance burdens, and utilize existing examination procedures, examination cycles and training programs. A further advantage of this arrangement would be that, for many dealers, regulation of their government related securities activities could be achieved

with a minimum of disruption to their business operations that might otherwise result from additional and separate examinations.

As is the case for municipal securities professionals, the SEC should be given authority to inspect and institute enforcement proceedings for both bank and non-bank dealers in order to assure a comprehensive system of regulation. In addition to the type of notification and consultation requirements applicable to SEC enforcement actions involving banks dealing in municipal securities, the SEC should be required to consult with the Council before bringing enforcement proceedings against government related securities dealers for violations of the rules of the Board or the Council.

The Council should be responsible for oversight of the Board to ensure that it is carrying out its statutory responsibilities. Clearing agencies for government related securities should be made subject to the same system of compliance and enforcement currently existing for clearing agencies registered with the SEC.

In view of the foregoing recommendations the study participants have drafted proposed legislation to establish a framework for supervised self-regulation in the markets for forward trading of federally guaranteed mortgage-backed securities. This legislative proposal is set forth as Appendix B to the Chapter.

# APPENDIX A

## DISCUSSION OF LOSSES AND COSTS OF REGULATION

This appendix contains a discussion of the losses incurred in the cases reviewed in Chapter IV and various other estimates of losses incurred primarily in the market for GNMA securities. It should be noted that while abusive trading practices were present in each case, no estimate is made of the portion of the losses attributable solely to the abusive practices. At the same time that these investors were suffering losses, other investors who had made investments in fixed income securities which could be considered prudent at the time may also have suffered losses because of unusually large fluctuations in interest rates.

The discussion of potential costs of regulation is an attempt to present the information that is available. It is not to be taken as a comprehensive estimate of the total cost of any proposed regulatory system. Many of the cost figures cited are simply rough estimates and should not be viewed as reliable indications of the cost of any proposed regulatory system.

### Losses

To the extent they can be estimated, the aggregate monetary losses for the cases reviewed in the Appendix to Chapter IV amount to between $85 and $111 million. Loss estimates for the 16 SEC proceedings total between $45 and $59 million. The estimates for the 12 pending SEC investigations total between $41 and $53 million.

In the cases summarized in the Appendix to Chapter IV, losses to broker-dealers amounted to approximately $15 to $17 million 1/ and losses to investors (including banks, credit unions, and individuals) amounted to approximately $70 to $94 million. 2/ While these losses were primarily incurred by the immediate parties to the transactions, the overcommitments and defaults by investors and dealers at times also affected the financial position of remote investors and dealers, in what might be called secondary or indirect effects. For example, in one case, it appears that defaults by customers of one dealer led to the dealer's involvency and inability to fulfill its commitments to other dealers. In another case, dealer overcommitments and misuse of customer funds led to substantial losses to the

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1/ Of this range, $3 million has been reimbursed by the mortgage banker involved in one of the transactions

2/ Of this range, $2.8 million has been reimbursed by the registered broker-dealers involved in 4 of the cases, and $8.6 million has been reimbursed in one other case through joint action by a mortgage banker and an interested governmental agency.

dealer's customers and other broker-dealers. This case also resulted in the bankruptcy of the dealer's registered affiliate, as well as the dealer's own bankruptcy. 3/

Total losses exceed the amounts involved in these SEC cases. As noted in Chapter IV, four instances of substantial losses by investors in GNMA mortgage backed securities have been reported in the news media since the beginning of 1980. Overextended positions and improper trading practices appear to have been contributing factors in all of these losses. The estimated losses in these cases have not been included in the tabulations of losses in this Appendix or in Chapter IV. 4/

Moreover, other information points to additional instances of problems and abuses. For example, the National Credit Union Administration ("NCUA") estimates that, at year end 1978, credit unions had unrealized losses of over $200 million on over $700 million of what the NCUA has termed "speculative" purchases primarily of GNMA's, although a few other types of government related securities were also involved. These purchases consisted of well over $200 million of forward commitments and also of purchases of GNMA's which were being financed under reverse repurchase agreements. The NCUA has also indicated that the possible insolvency and liquidation of 12 credit unions due to losses primarily in GNMA mortgage-backed securities transactions was averted as a result of $8 million in loans made by NCUA. All of the transactions involved in these instances were entered into prior to the adoption of new rules by NCUA designed to limit speculative trading by credit unions.

Other federal agencies also have reported significant losses by the entities under their regulatory jurisdiction. The Comptroller of the Currency reported that, by the beginning of 1980, its bank examiners had discovered approximately 40 cases of trading abuses and unsuitable speculative investment practices by national banks, though no cumulative cost estimate was available. Other bank regulatory agencies also noted cases of abusive practices, mainly in the form of unsuitable speculation by banks in GNMA forward contracts, discovered by their examiners. Likewise, the Federal Home Loan Bank Board has indicated that perhaps about 100 of its institutions had experienced problem situations due to overcommitments or improper accounting procedures with respect to government related securities.

Beyond these monetary losses, abuses in the trading of government related securities may also impose other economic costs on the society in general and on the markets for these securities in particular. If the

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3/ The registered affiliate went bankrupt because of its guarantee of certain of the unregistered dealer's transactions, not because of trading practices on the part of the registered affiliate.

4/ See page 89, *supra*.

integrity of the markets for these securities becomes questionable because of the practices of certain participants in the market, investor confidence and dealers' willingness to participate in these markets will be reduced. If investors and dealers were to avoid these markets, thereby reducing demand and trading activity, market interest rates on government related securities would rise. In the case of mortgage-backed securities, such a move by investors could result in an increased cost of mortgage origination. Indeed GNMA and some other government agencies that administer government related securities programs, or contemplate initiating such programs, are concerned that continued abuses in the trading of their, or other, government related securities might seriously impair market acceptance of their securities.

## Costs of Regulation

A wide variety of possible regulatory systems might be employed to implement regulatory measures. The measurable costs of these possible regulatory systems are impossible to estimate accurately, but some impression can be gained of relative magnitude by reviewing the costs involved in the recently imposed regulation of the municipal securities market. Intangible costs, such as the possibility of increased dealer spreads and a reduction in market liquidity, are even more difficult to measure, and no effort has been made to quantify estimates of such costs.

Some data have been collected and seem appropriate for examination. Government related securities, like municipal securities prior to the enactment of the 1975 Amendments, generally are subject only to the anti-fraud provisions of the federal securities laws. Moreover, the regulations imposed on municipal securities dealers involved nearly the full range of measures (except for initial and maintenance margins) that might be adopted if a comprehensive system of regulation were selected for GNMA and FHLMC mortgage backed securities. 5/

In examining the costs arising from establishment of a regulatory system for the municipal securities markets, it is helpful, but not conclusive, to consider two main categories: administrative agency costs and dealer costs.

## Administrative Agency Costs

The MSRB, the rulemaking body for municipal transactions, in fiscal year 1976 (the first full year of its existence), had expenses of $704,584

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5/ Costs would depend to some degree on the extent to which various sectors of the government related securities markets were brought under regulation.

reflecting expenditures for salaries, meetings, travel, etc. In fiscal year 1979, MSRB expenses were $866,323, a small increase over the start-up year. 6/

The NASD, in its role as inspection and enforcement agency for its member firms with respect to MSRB rules, expanded its existing programs and initiated others to deal with its new responsibilities in the municipal securities area. As a result of the 1975 Amendments, the NASD added 46 examiners to its nationwide field staff at a cost of approximately $600,000 in order to provide additional regulatory coverage for the approximately 650 existing municipal securities firms which were then NASD members and over 200 municipal securities firms subsequently admitted to membership in the NASD. Each municipal securities firm member is inspected annually by the NASD. This inspection encompasses all aspects of the dealer's business. 7/ Allocation of the $600,000 among the more than 200 new firms results in a per-firm figure in the range of $3,000. This is roughly comparable to the NASD's overall per-firm inspection costs. For calendar year 1978 (the latest figures available), the NASD spent approximately $10.6 million for on-site inspection and review of its 2,813 members, 8/ or about $3,800 per member. 9/

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6/ The MSRB obtains its funds from municipal securities brokers and dealers. Most of its revenues are generated by an underwriting assessment which in the MSRB's first year was five cents per $1,000 of the par value of all new issue municipal securities (other than short-term notes) purchased by or through these firms. By late 1977, the underwriting fee was reduced to one cent per $1,000 because the prior assessment produced a surplus. We understand that the MSRB intends to raise this fee to two cents per $1,000 when that surplus is exhausted. In addition, each municipal securities broker municipal securities dealer that registers with the SEC is required to pay to the MSRB an initial fee of $100 and an annual fee of $100.

7/ There are approximately 646 municipal securities firms that are members of the NASD and are also members of exchanges, and for certain exchange member firms the exchanges have usually been designated to perform the financial inspections, while the NASD continues its routine inspections of their operations.

8/ On the revenue side, 44 percent of NASD's revenues ($8.8 million) for fiscal year 1979 came from assessments on member firms: $300 per year/per firm, $5 per person, and an assessment on gross income from nonmunicipal securities transactions equaling .25 percent and .21 percent for municipal securities income. In addition, NASD charges an initial membership fee of $500 per firm. These fees support the NASD's activities with respect to both corporate and municipal securities. It may be noted that over half of NASD firms have no municipal business; and of the approximately 1,250 firms that do transact some municipal business, a large number do relatively little continuing municipal business.

9/ Little additional expense was incurred by the SEC as a result of regulation in the municipal securities area, primarily because of its role in this area is limited principally to oversight of MSRB and NASD activities and to enforcement activities, some of which have been carried out under the antifraud rules with or without additonal regulation in this market sector.

Of the 333 banks that registered with the SEC as municipal securities dealers, 229 are national banks inspected by the Comptroller of the Currency; 49 are state banks in the Federal Reserve System inspected by that agency; and 55 are state nonmember banks inspected by the FDIC. These bank regulators have experienced some additional costs because of the extra training of inspectors and the extension of bank inspections to check compliance with MSRB requirements. 10/ However, most inspections of municipal securities activities can coincide with regular bank inspections.

Dealer Costs

From the viewpoint of individual dealers, the MSRB and NASD fees and survey completed in May 1978 by the MSRB suggested that municipal securities dealers (both bank and nonbank dealers) expended, on the average, approximately $33,000 per firm in start-up costs, although the data from this survey do not appear to be complete or definitive. 11/ The best judgment as to the allocation of this expense was that it represented primarily (1) the salary of a "compliance officer," or someone who took the time to learn about the new MSRB rules in order to ensure that the firm was in compliance; and (2) changes in recordkeeping in order to conform to the new MSRB requirements. Of course, some firms had very few changes to make in their compliance procedures or recordkeeping while others needed, or desired, to institute new systems.

It is not entirely clear whether the estimates of dealer costs provided by the MSRB provide a full indication of all the costs that typical dealers in municipal securities incurred in connection with municipal securities regulation or whether the municipal experience can be assumed to be fully representative of the costs that would be involved in regulating trading in government related securities. Based on recent informal conversations by officials of PSA with a few large municipal securities dealers, it appears that some of the largest individual dealers incurred start-up costs that substantially exceeded the average reported alone.

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10/ The FDIC estimates that in 1979 its added costs for municipal inspections totalled $22,000, an average of $400 per firm. However, this per firm average cost may be the lowest average cost for the three bank regulatory agencies, since the municipal securities dealer-banks under the FDIC's jurisdiction are among the smallest of the dealer-banks. Also, attempting to extrapolate average inspection costs from the municipal market to the market for GNMA and FHLMC securities may be difficult because the average size of GNMA and FHLMC dealers is believed to be larger than the average size of dealer-banks in the municipal market.

11/ The MSRB received responses from only about 1/3 of the firms to which it sent questionnaires. It is impossible to determine whether the firms that replied to the survey had a disproportionately higher or lower cost than those that did not respond.

No comparable survey data on continuing annual dealer costs are available. MSRB and NASD officials believe that continuing annual dealer costs are comparable to, or smaller than, the start-up costs. In our interviews, these officials pointed to recordkeeping requirements and the cost of a compliance officer as constituting the main ongoing costs. They emphasized that, in their opinion, the "fair practice" rules of the MSRB are sound business principles and should not impose substantial new costs on firms. Officials of both the MSRB and the NASD also stressed that the new scheme for municipal securities regulation has resulted in certain cost savings to broker-dealers. For example, standardized settlement and clearance procedures for municipal transactions have increased efficiency and certainty in the market place and have decreased the number of disputes. When disputes do arise, arbitration procedures can help to reduce court costs and delays.

In reviewing the above discussion of costs associated with regulation of the municipal securities market, it should be noted that three factors may tend to lessen the cost of regulation of government related securities relative to that for municipal securities. First, there are currently only about 60 to 80 firms (including approximately 25 banks) actively dealing in GNMA and FHLMC mortgage-backed securities. By contrast, within a year after the enactment of the 1975 Amendments, approximately 310 bank municipal securities dealers and 232 broker-dealers were required to register with the SEC. Second, of these 60 to 80 firms, some are already registered with the SEC. For these firms, any additional regulatory requirements should not be extensive since their recordkeeping and compliance procedures are already in place. Third, inspections are already being conducted by bank regulators or the NASD with respect to all the bank dealers and some of the non-bank dealers in government related securities because of these dealers' activities in the corporate or municipal securities markets. Most of the regulators interviewed for this study believed that the changes needed to expand inspections to include the government securities activities of these dealers would not be extensive.

On the other hand, one factor might tend to increase the per-firm costs of regulation. It seems a certainty that, if regulation is to be extended to delayed-delivery trading in GNMA and FHLMC mortgage-backed securities, initial and maintenance margin requirements, which do not exist in the regulatory system for municipal securities, will be imposed and the costs of enforcing and complying with these regulations could be significant. The additional capital required of dealers, investors, and mortgage bankers because of initial and maintenance margin requirements will also be an additional cost to the market. Further, aside from any regulatory costs imposed on the firms subjected to regulation, there are also potential indirect costs to the markets in the form of regulatory barriers to entry. In particular, if some of the less active dealers were to find the added costs of regulation too burdensome, they might decide to cease doing business in that market, conceivably reducing the competitive performance of the market. The added costs to the market arising from regulation might also cause a shift of activity from the regulated market to unregulated areas.

# APPENDIX B

## GOVERNMENT RELATED SECURITIES ACT OF 1980

To provide greater protection for investors in government-related securities, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

TITLE I --

SECTION 1. Short Title and Relationship to Securities Exchange Act of 1934.

(a) This Act may be cited as the "Government-Related Securities Act of 1980."

(b) Except as otherwise provided in the Government-Related Securities Act of 1980, the provisions of the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.) apply as if all provisions of this Act constituted an amendment to, and were included as a section of, such Act.

SECTION 2. Necessity for Regulation.

Transactions in government-related securities, as commonly conducted, are affected with a national public interest which makes it necessary to provide for control of such transactions and of matters and practices related thereto, to require appropriate reports, to remove impediments to and perfect a national system for the clearance and settlement of government-related securities transactions and to impose requirements necessary to make such regulation effective, in order to protect investors, the national credit, the national banking system, and to ensure the maintenance of fair and honest markets in such securities.

SECTION 3. Definitions and Application.

(a) When used in the Government-Related Securities Act of 1980, unless the context otherwise requires --

(1) The term "1980 Act" means the provisions of the Government-Related Securities Act of 1980.

(2) The term "government-related securities" means those securities designated in accordance with section 3(b) of the 1980 Act.

(3) The terms "government-related securities broker" and "government-related securities dealer" have the same meaning as those terms have in the Securities Exchange Act of 1934.

(4) The term "government-related securities clearing agency" means a clearing agency (as that term is defined in section 3(a)(23) of the Securities Exchange Act of 1934) that functions as such in connection with transactions in government-related securities.

(5) The term "appropriate regulatory agency" --

(A) when used with respect to the Federal Mortgage-Backed Securities Rulemaking Board, means the Government-Related Securities Oversight Council;

(B) when used with respect to all other persons, is defined in section 3(a)(34) of the Securities Exchange Act of 1934.

(6) The term "interested agency" means any governmental issuer or guarantor of government-related securities or securities proposed to be designated as government-related securities that notifies the Government-Related Securities Oversight Council and the Federal Mortgage-Backed Securities Rulemaking Board that such issuer or guarantor requests to be consulted in accordance with the requirements of this title.

(b)(1) Mortgage-backed securities guaranteed by the Government National Mortgage Association and mortgage-backed securities that are issued or guaranteed by the Federal Home Loan Mortgage Corporation are hereby designated as government-related securities: Provided, however, That transactions other than forward transactions in such securities shall not be regulated under, nor subject to the provisions of, sections 5, 7, 8, 9(b) and 10 of the 1980 Act or section 7 of the Securities Exchange Act of 1934, and shall be deemed to be transactions in "exempted securities" for purposes of this title, notwithstanding the provisions of Section 3(a)(12) of the Securities Exchange Act of 1934 under which government-related securities are deemed not to be exempted securities for purposes of that Act, unless the Government-Related Securities Oversight Council (hereinafter in 1980 Act referred to as the "Council"), by rule, determines that regulation of such transactions is necessary or appropriate in the public interest, for the protection of investors, or for the orderly regulation of forward transactions. Any rule adopted under this subsection shall require approval by all members of the Council.

(2) As it deems necessary or appropriate in the public interest or for the protection of investors, the Council, with the approval of all of its members, may by rule designate as government-related securities additional obligations of, or obligations guaranteed as to principal or interest by, any agency, corporation, or instrumentality of the United States or in which the United States has a direct or indirect interest, except that the Council shall have no authority to designate as government-related securities any securities issued by the United States Department of the Treasury.

(3) The Council, by rule, shall define the term "forward transactions."

(c) The authority of the Federal Mortgage-Backed Securities Rulemaking Board to regulate transactions in securities guaranteed by the Government National Mortgage Association and issued or guaranteed by the Federal Home Loan Mortgage Corporation shall be limited to forward transactions, as that term is defined by the Council: Provided, however, That to the extent necessary or appropriate for the orderly regulation of forward transactions, such regulation, with the unanimous approval of the Council, may be extended to other transactions in such government-related securities effected by brokers, dealers, and public securities dealers which engage in forward transactions in the same securities: Provided, however, That nothing in this subsection shall limit the authority of the Council to extend the scope of the authority of the Federal Mortgage-Backed Securities Rulemaking Board under the procedures set forth in subsection (b).

(d) No provision of this title shall apply to, or be deemed to include, any agency, corporation, or instrumentality of the United States or in which the United States has a direct or indirect interest, or any officer, agent, or employee of any such agency, corporation, or instrumentality acting in the course of his official duty as such, unless such provision makes specific reference to such agency, corporation or instrumentality, or to an "interested agency" as defined in Section 3(a)(6) of the 1980 Act.

SECTION 4. Government-Related Securities Oversight Council.

(a) There is hereby established a Government-Related Securities Oversight Council to be composed of the Secretary of the Treasury or his designee, the Chairman of the Board of Governors of the Federal Reserve System or his designee, and the Chairman of the Securities and Exchange Commission or his designee. The members of the Council shall choose a chairman from among themselves.

(b) The Council shall have no separate staff, but shall utilize such personnel of, and consultants to, the Department of the Treasury, the Board of Governors of the Federal Reserve System, and the Securities and Exchange Commission as are assigned to the Council by such agencies.

(c) Except for the functions performed in subsections 3(b) and 3(c) of the 1980 Act, the Council shall have the authority to delegate, by published order or rule, any of its functions to the Department of the Treasury, the Board of Governors of the Federal Reserve System, the Securities and Exchange Commission, any employee of any such agency assigned to the Council, or to an individual member of the Council or his designee, including functions with respect to hearing, determining, ordering, certifying, reporting, rulemaking, or otherwise acting as to any work, business, or matter: Provided, however, That nothing herein contained shall be deemed to supersede the provisions of section 7(a) of the Administrative Procedure Act of 1946 (5 U.S.C. 556). The Council may, in its discretion, by published order or rule, withdraw delegated authority or any portion thereof, including authority delegated pursuant to subsection (d) of this section.

(d) With respect to the provisions in sections 5 and 8 of the 1980 Act applicable to brokers, dealers, and public securities dealers, and the provisions in sections 7, 8, and 9 of the 1980 Act applicable to clearing agencies, the Council is directed, within thirty days of the enactment of the 1980 Act, to delegate its authority to the Securities and Exchange Commission.

(e) With respect to the delegation of any of its functions other than rulemaking, the Council shall retain a discretionary right to review the action of any person, office, division, or agency, upon its own initiative or upon

petition of any aggrieved person in such action, within such time and in such manner as the Council by rule, shall prescribe: Provided, however, That the vote of one member of the Council shall be sufficient to bring any such action before the Council for review.

SECTION 5. <u>Registration of Government-Related Securities Brokers and Government-Related Securities Dealers</u>.

(a)(1) It shall be unlawful for any government-related securities broker or government-related securities dealer (other than a broker, dealer, or public securities dealer registered as such with the Securities and Exchange Commission) to make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any government-related security unless such government-related securities broker or government-related securities dealer is registered in accordance with subsection (b) of this section.

(2) Any provision of the 1980 Act (other than subsection (a)(1) of this section) which prohibits any act, practice, or course of business if the mails or any means or instrumentality of interstate commerce is used in connection therewith shall also prohibit any such act, practice, or course of business by any broker, dealer, or public securities dealer registered pursuant to this section or section 15 of the Securities Exchange Act of 1934, or any person acting on behalf of such broker, dealer, or public securities dealer, irrespective of any use of the mails or any means or instrumentality of interstate commerce in connection therewith.

(3) The Council, by rule or order, upon its own motion or upon application, may conditionally or unconditionally exempt any broker, dealer, or public securities dealer or class of brokers, dealers, or public securities dealers from any provision of this section or any rule of the Federal Mortgage-Backed Securities Rulemaking Board if the Council deems such exemption consistent with the public interest, the protection of investors, and the purposes of this title.

(b)(1) A government-related securities broker or government-related securities dealer may be registered by filing with the Council an application for registration in such form and containing such information and documents concerning such government-related securities broker or government-related securities dealer and any persons associated with such government-related securities broker or government-related securities dealer as the Council, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors. Within forty-five days of the date of the filing of such application (or within such longer period as to which the applicant consents), the Council shall --

(A) by order grant registration, or

(B) institute proceedings to determine whether registration should be denied. Such proceedings shall include notice of the grounds for denial under consideration and opportunity for hearing and shall be concluded within one hundred twenty days of the date of the filing of the application for registration. At the conclusion of such proceedings, the Council, by order, shall grant or deny such registration. The Council may extend the time for conclusion of such proceedings for up to ninety days if it finds good cause for such extension and publishes its reasons for so finding or for such longer period as to which the applicant consents.

The Council shall grant such registration if the Council finds that the requirements of this section are satisfied. The Council shall deny such registration if it does not make such a finding or if it finds that if the applicant were so registered, its registration would be subject to suspension or revocation under paragraph (4) of subsection 15(b) of the Securities Exchange Act of 1934.

(2) An application for registration of a government-related securities broker or government-related securities dealer to be formed or organized may be made by a government-related securities broker or government-related securities dealer to which the government-related securities broker or government-related securities dealer to be formed or organized is to be the successor. Such application, in such form as the Council, by rule, may prescribe, shall contain such information and documents concerning the applicant, the

successor, and any persons associated with the applicant or successor, as the Council, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors. The grant or denial of registration to such an applicant shall be in accordance with the procedures set forth in paragraph (1) of this subsection. If the Council grants such registration, the registration shall terminate on the forty-fifth day after the effective date thereof, unless prior thereto the successor shall, in accordance with such rules and regulations as the Council may prescribe, adopt the application for registration as its own. Any registered government-related securities broker or government-related securities dealer may, upon such terms and conditions as the Council deems necessary or appropriate in the public interest or for the protection of investors, withdraw from registration by filing a written notice of withdrawal with the Council. If the Council finds that any registered government-related securities broker or government-related securities dealer is no longer in existence or has ceased to do business as a government-related securities broker or government-related securities dealer, the Council, by order, shall cancel the registration of such government-related securities broker or government-related securities dealer.

SECTION 6. <u>Federal Mortgage-Backed Securities Rulemaking Board</u>.

(a)(1) Not later than one hundred twenty days after the date of enactment of the 1980 Act, the Council shall establish a Federal Mortgage-Backed Securities Rulemaking Board (hereinafter in the 1980 Act referred to as the "FMSRB").

(A) The FMSRB shall be composed initially of seven members appointed by the Council, after consultation with the Securities and Exchange Commission, the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Board of Directors of the Federal Deposit Insurance Corporation, the National Credit Union Administration Board, the Federal Home Loan Bank Board, the Government National Mortgage Association, and the Federal Home Loan Mortgage Corporation, and shall perform the duties set forth in this section. The initial members of the FMSRB shall serve as members for a term of two years, and shall

consist of at least two individuals who are not associated with the government-related securities industry (at least one of whom is representative of investors in government-related securities) and at least four individuals who are associated with and representative of government-related securities brokers and bank and non-bank government-related securities dealers.

(B) The Council, by rule, may as it deems appropriate increase the number of members of the FMSRB and specify the nature of their affiliations, in order to assure fair representation of government-related securities brokers and government-related securities dealers who trade in newly designated government-related securities, as well as persons (including investors) interested in such newly designated government-related securities. The Council, by rule, may as it deems appropriate rename the FMSRB to reflect newly designated government-related securities.

(C) Prior to the expiration of the terms of office of the initial members of the FMSRB, an election shall be held under rules adopted by the FMSRB (pursuant to subsection (a)(2)(C) of this section) of the members to succeed such initial members.

(2) The FMSRB shall propose and adopt rules to effect the purposes of the 1980 Act with respect to transactions in government-related securities effected by brokers, dealers, and public securities dealers. (Such rules are hereinafter collectively referred to in this section as "rules of the FMSRB.") The rules of the FMSRB, as a minimum, shall:

(A) as the FMSRB deems necessary or appropriate in order to preserve the financial integrity of the markets for government-related securities, regulate the amount of deposit that may be initially required and subsequently maintained in connection with the purchase, sale, or carrying of any government-related security. Such rules and regulations may make appropriate provision with respect to the type of deposit or collateral which may be furnished; the carrying of undermargined accounts for limited periods and under specified conditions; the withdrawal of funds or securities; the substitution or additional purchase of securities; the transfer of accounts from one lender

to another; special or different margin requirements for delayed deliveries, short sales, and arbitrage transactions; the bases and methods to be used in calculating loans, and margins and market prices; and similar administrative adjustments and details. In developing any such requirements the FMSRB shall consult with the Board of Governors of the Federal Reserve System with respect to the impact and appropriateness of any proposed requirements.

(B) if the FMSRB deems it appropriate, with respect to the rules adopted pursuant to this section 6, classify securities, types of securities transactions, persons, applications, reports, and other matters, and prescribe greater, lesser, or different standards with respect to such different classes.

(C) establish fair procedures for the nomination and election of members of the FMSRB and assure fair representation in such nominations and elections of government-related securities brokers and government-related securities dealers. Such rules shall provide that the membership of the FMSRB shall at all times be apportioned in the manner set forth in subsection (a)(1) and any rule thereunder, and that the public representatives shall be subject to approval by the Council to assure that no one of them is associated with the government-related securities industry, and that at least one is representative of investors in government-related securities. Such rules shall also specify the term members shall serve.

(D) provide for the operation and administration of the FMSRB, including the selection of a Chairman from among the members of the FMSRB, the compensation of the members of the FMSRB, and the appointment and compensation of such employees, attorneys, and consultants as may be necessary or appropriate to carry out the FMSRB's functions under this section.

(E) provide that each government-related securities broker and each government-related securities dealer shall pay to the FMSRB such reasonable fees and charges as may be necessary or appropriate to defray the costs and expenses of operating and administering the FMSRB. Such rules shall specify the amount of such fees and charges.

(F) prescribe records to be made and kept by government-related securities brokers and government-related securities dealers and the periods for which such records shall be preserved: Provided, however, That, in order to avoid undue regulatory burdens for government-related securities brokers and government-related securities dealers, any such requirements shall be, to the extent feasible, similar to the requirements for records to be made, kept, and preserved by brokers, dealers, and municipal securities dealers.

(G) provide for the periodic examination in accordance with subsection (c)(1) of this section of government-related securities brokers and government-related securities dealers to determine compliance with applicable provisions of this title, the rules and regulations thereunder, and the rules of the FMSRB. Such rules shall specify the minimum scope and frequency of such periodic examinations and shall be designed to avoid unnecessary regulatory duplication or undue regulatory burdens for any such government-related securities broker or government-related securities dealer by, to the extent possible, coordinating examination requirements with those established for municipal securities brokers and municipal securities dealers by the Municipal Securities Rulemaking Board.

(H) be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market in government-related securities, and, in general, to protect investors and the public interest; and not be designed to permit unfair discrimination between customers, issuers, guarantors, government-related securities brokers, or government-related securities dealers, to fix minimum profits, to impose any schedule or fix rates of commissions, allowances, discounts, or other fees to be charged by government-related securities brokers or

government-related securities dealers, to regulate by virtue of any authority conferred by the 1980 Act matters not related to the purposes of the 1980 Act with respect to government-related securities or the administration of the FMSRB, or to impose any burden on competition not necessary or appropriate in furtherance of the purposes of the 1980 Act.

(I) if the FMSRB deems appropriate, specify activities, in addition to those included in section 3(a)(42) of the Securities Exchange Act of 1934 which the FMSRB determines are integral to the conduct of business as a government-related securities dealer, and require those activities to be conducted within any separately identifiable department or division.

(J) if the FMSRB deems appropriate, provide that no government-related securities broker or government-related securities dealer shall effect any transaction in, or induce or attempt to induce the purchase or sale of, any government-related security unless such government-related securities broker or government-related securities dealer meets such standards of operational capability and such government-related securities broker or government-related securities dealer and every natural person associated with such government-related securities broker or government-related securities dealer meet such standards of training, experience, competence, and such other qualifications as the FMSRB finds necessary or appropriate in the public interest or for the protection of investors. In connection with the definition and application of such standards the FMSRB may --

(i) appropriately classify government-related securities brokers and government-related securities dealers (taking into account relevant matters, including types of business done, nature of securities other than government-related securities sold, and character of business organization), and persons associated with government-related securities brokers and government-related securities dealers;

(ii) specify that all or any portion of such standards shall be applicable to any such class;

(iii) require persons in any such class to pass tests administered in accordance with subsection (c)(1) of this section; and

(iv) provide that persons in any such class other than government-related securities brokers and government-related securities dealers and partners, officers, and supervisory employees of government-related securities brokers or government-related securities dealers, may be qualified solely on the basis of compliance with such standards of training and such other qualifications as the FMSRB finds appropriate.

(K) if the FMSRB deems appropriate, include provisions governing the form and content of quotations relating to government-related securities which may be distributed or published by any government-related securities broker, government-related securities dealer, or person associated with such a government-related securities broker or government-related securities dealer, and the persons to whom such quotations may be supplied. Such rules relating to quotations shall be designed to produce fair and informative quotations, to prevent fictitious or misleading quotations, and to promote orderly procedures for collecting, distributing, and publishing quotations.

(L) if the FMSRB deems appropriate, provide for the arbitration of claims, disputes, and controversies relating to transactions in government-related securities: Provided, however, That no person other than a government-related securities broker, government-related securities dealer, or person associated with such a government-related securities broker or government-related securities dealer may be compelled to submit to such arbitration except at his instance and in accordance with section 29 of the Securities Exchange Act of 1934.

(b) The FMSRB is not authorized under this title to require any issuer or guarantor of government-related securities, directly or indirectly through a government-related securities broker or government-related securities dealer or otherwise, to furnish to the FMSRB or to a purchaser or prospective purchaser of such securities any

application, report, document, or information with respect to such issuer or guarantor: Provided, however, That the FMSRB may require government-related securities brokers and government-related securities dealers to furnish to the FMSRB or purchasers or prospective purchasers of government-related securities applications, reports, documents, and information with respect to the issuer or guarantor thereof which are generally available from a source other than such issuer or guarantor.

(c)(1) Tests required pursuant to subsection (a)(2)(J)(iii) of this section shall be administered by or on behalf of and periodic examinations pursuant to subsection (a)(2)(G) of this section shall be conducted by --

(A) a registered securities association or a national securities exchange, in the case of government-related securities brokers and government-related securities dealers who are members of such association or exchange; and

(B) the appropriate regulatory agency for any government-related securities broker or government-related securities dealer, in the case of all other government-related securities brokers and government-related securities dealers.

(2) An appropriate regulatory agency, registered securities association, or national securities exchange shall make a report of any examination conducted pursuant to subsection (a)(2)(G) of this section and, upon request, shall promptly furnish the Securities and Exchange Commission or the Council a copy thereof and any data supplied to it in connection with such examination. Subject to such limitations as the Council, by rule, determines to be necessary or appropriate in the public interest or for the protection of investors, the Council shall, upon request, make available to the FMSRB a copy of any report of an examination of a government-related securities broker or government-related securities dealer furnished to the Council pursuant to this paragraph.

(d) No government-related securities broker or government-related securities dealer registered pursuant to section 5 of the 1980 Act shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any government-related security in contravention of such rules and regulations as the FMSRB shall prescribe as necessary or appropriate in the public interest or for the protection of investors to provide safeguards with respect to the financial responsibility and related practices of such government-related securities brokers and government-related securities dealers including, but not limited to, the acceptance of custody and use of customers' securities, and the carrying and use of customers' deposits or credit balances. Such rules and regulations shall require the maintenance of reserves with respect to customers' deposits or credit balances, as determined by such rules and regulations.

(e) No broker, dealer, or public securities dealer shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any government-related security in contravention of any rule of the FMSRB.

(f) The Council is authorized, by order, if in its opinion such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the 1980 Act, to remove from office or censure any member or employee of the FMSRB, who, the Council finds, on the record after notice and opportunity for hearing, has willfully (A) violated any provision of this title, the rules and regulations thereunder, or the rules of the FMSRB, or (B) abused his authority.

(g) The FMSRB shall file with each agency enumerated in section 3(a)(34) of the Securities Exchange Act of 1934 and with every interested agency as defined in Section 3(a)(6) of the 1980 Act copies of every proposed rule change filed with the Council pursuant to section 9(a) of the 1980 Act.

(h)(1) The FMSRB shall make and keep for prescribed periods such records, furnish such copies thereof, and make and disseminate such reports, as the Council, by rule,

prescribes as necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the 1980 Act.

(2) All records of the FMSRB are subject at any time, or from time to time, to such reasonable, periodic, special, or other examinations by representatives of the Council as the Council deems necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the 1980 Act.

SECTION 7. <u>Government-Related Securities Clearing Agencies</u>.

(a)(1) With respect to government-related securities, the Congress adopts the findings in section 17A of the Securities Exchange Act of 1934 and, in addition, finds that --

(A) transactions in government-related securities, particularly transactions entered into on a delayed delivery or optional delivery basis, may pose serious financial risks prior to settlement for underwriters, buyers, and sellers of such securities, place substantial demands on banks and the national banking system, and affect the national credit;

(B) availability of information with respect to the volume of transactions in and value of unsettled obligations with respect to government-related securities is desirable to assure the fairness, orderliness, efficiency, and integrity of the markets for government-related securities; and

(C) a comprehensive system for the clearance and settlement of transactions in government-related securities would provide an efficient and effective means of reducing risks associated with unsettled obligations in government-related securities, and strengthening the markets for government-related securities.

(2) The Council, the Securities and Exchange Commission, the Secretary of the Treasury, the Board of Governors of the Federal Reserve System, the Federal Home Loan Bank Board,

the National Credit Union Administration Board, the Comptroller of the Currency, the Board of Directors of the Federal Deposit Insurance Corporation, and each agency, corporation, or instrumentality of the United States or in which the United States has a direct or indirect interest and which is an issuer or guarantor of government-related securities are directed, therefore, having due regard for their various and unique responsibilities with respect to financing programs supported by, issuance of, operation of the market for, and sales practices associated with government-related securities, to use their respective authorities in a coordinated and cooperative manner to encourage and facilitate the establishment, to the extent feasible, of a comprehensive system for clearance and settlement of government-related securities suitable for use by all persons directly involved in the issuance, underwriting, sale and purchase of government-related securities.

(b)(1) Except as otherwise provided in this section, it shall be unlawful for any clearing agency, unless registered in accordance with this subsection or in accordance with section 17A of the Securities Exchange Act of 1934, directly or indirectly, to make use of the mails or any means or instrumentality of interstate commerce to perform the functions of a clearing agency with respect to any government-related security. The Council, by rule or order, upon its own motion or upon application, may conditionally or unconditionally exempt any clearing agency or government-related security or any class of clearing agencies or government-related securities from any provisions of this section or the rules or regulations thereunder, if the Council finds that such exemption is consistent with the public interest, the protection of investors, and the purposes of this section, including the prompt and accurate clearance and settlement of government-related securities transactions and the safeguarding of government-related securities and funds.

(2) A government-related securities clearing agency may be registered under the terms and conditions hereinafter provided in this subsection, by filing with the Council an application for registration in such form as the Council, by rule, may prescribe containing the rules of the clearing

agency and such other information and documents as the Council, by rule, may prescribe as necessary or appropriate in the public interest or for the prompt and accurate clearance and settlement of government-related securities transactions.

(c)(1) The Council shall, upon filing of an application for registration as a government-related securities clearing agency, publish notice of the filing and afford interested persons an opportunity to submit written data, views, and arguments concerning such application. Within ninety days of the date of publication of such notice (or within such longer period as to which the applicant consents), the Council shall

(A) by order grant such registration, or

(B) institute proceedings to determine whether registration should be denied. Such proceedings shall include notice of the grounds for denial under consideration and opportunity for hearing and shall be concluded within one hundred eighty days of the date of publication of notice of the filing of the application for registration. At the conclusion of such proceedings the Council, by order, shall grant or deny such registration. The Council may extend the time for conclusion of such proceedings for up to ninety days if it finds good cause for such extension and publishes its reasons for so finding or for such longer period as to which the applicant consents.

The Council shall grant such registration if it finds that the requirements of the 1980 Act and the rules and regulations thereunder with respect to the applicant are satisfied. The Council shall deny such registration if it does not make such finding.

(2) A government-related securities clearing agency shall not be registered unless the Council determines that --

(A) Such clearing agency is so organized and has the capacity to be able to facilitate the prompt and accurate clearance and settlement of securities transactions for which it is responsible, to safeguard securities and funds in its custody or control or for

which it is responsible, to comply with the provisions of the 1980 Act and the rules and regulations thereunder, to enforce (subject to any rule or order of the Securities and Exchange Commission pursuant to section 17(d) or 19(g)(2) of the Securities Exchange Act of 1934) compliance by its participants with the rules of the clearing agency, and to carry out the purposes of this section.

(B) Subject to the provisions of paragraph 17A(b)(4) of the Securities Exchange Act of 1934, the rules of the clearing agency provide that any (i) broker or dealer registered with the Council or the Securities and Exchange Commission, (ii) other clearing agency registered with the Council or with the Securities and Exchange Commission, (iii) registered investment company, (iv) bank, (v) insurance company, or (vi) other person or class of persons as the Council by rule, may from time to time designate as appropriate to the development of a national system for the prompt and accurate clearance and settlement of government-related securities transactions may become a participant in such clearing agency.

(C) The rules of the clearing agency assure a fair representation of its shareholders (or members) and participants in the selection of its directors and administration of its affairs. (The Council may determine that the representation of participants is fair if they are afforded a reasonable opportunity to acquire voting stock of the clearing agency, directly or indirectly, in reasonable proportion to their use of such clearing agency.)

(D) The rules of the clearing agency provide for the equitable allocation of reasonable dues, fees, and other charges among its participants.

(E) The rules of the clearing agency do not impose any schedule of prices, or fix rates or other fees, for services rendered by its participants.

(F) The rules of the clearing agency are designed to promote the prompt and accurate clearance and settlement of government-related securities transactions, to assure the safeguarding of securities and funds which are in the custody or control of the clearing agency or for which it is responsible, to foster cooperation and coordination with persons engaged in the clearance and settlement of securities transactions, and, in general, to protect investors and the public interest; and are not designed to permit unfair discrimination in the admission of participants or among participants in the use of the clearing agency, or to regulate by virtue of any authority conferred by this title matters not related to the purposes of this section or the administration of the clearing agency.

(G) The rules of the clearing agency provide that (subject to any rule or order of the Securities and Exchange Commission pursuant to section 17(d) or 19(g)(2) of the Securities Exchange Act of 1934) its participants shall be appropriately disciplined for violation of any provision of the rules of the clearing agency by expulsion, suspension, limitation of activities, functions, and operations, fine, censure, or any other fitting sanction.

(H) The rules of the clearing agency are in accordance with the provisions of paragraph 17A(b)(5) of the Securities Exchange Act of 1934 and, in general, provide a fair procedure with respect to the disciplining of participants, the denial of participation to any person seeking participation therein, and the prohibition or limitation by the clearing agency of any person with respect to access to services offered by the clearing agency.

(I) The rules of the clearing agency do not impose any burden on competition not necessary or appropirate in furtherance of the purposes of this title.

(3) With respect to an application for registration pursuant to this section filed by a government-related securities clearing agency--

(A) The Council shall not grant registration prior to the sixtieth day after the date of publication of notice of the filing of such application unless the appropriate regulatory agency for such clearing agency has notified the Council of such appropriate regulatory agency's determination that such clearing agency is so organized and has the capacity to be able to safeguard securities and funds in its custody or control or for which it is responsible and that the rules of such clearing agency are designed to assure the safeguarding of such securities and funds.

(B) The Council shall institute proceedings in accordance with paragraph (1)(B) of this subsection to determine whether registration should be denied if the appropriate regulatory agency for such clearing agency notifies the Council within sixty days of the date of publication of notice of the filing of such application of such appropriate regulatory agency's (i) determination that such clearing agency may not be so organized or have the capacity to be able to safeguard securities or funds in its custody or control or for which it is responsible or that the rules of such clearing agency may not be designed to assure the safeguarding of such securities and funds and (ii) reasons for such determination.

(C) The Council shall deny registration if the appropriate regulatory agency for such clearing agency notifies the Council prior to the conclusion of proceedings instituted in accordance with paragraph (1)(B) of this subsection of such appropriate regulatory agency's (i) determination that such clearing agency is not so organized or does not have the capacity to be able to safeguard securities or funds in its custody or control or for which it is responsible or that the rules of such clearing agency are not designed to assure the safeguarding of such securities or funds and (ii) reasons for such determination.

(4) A government-related securities clearing agency may, upon such terms and conditions as the Council, by rule, deems necessary or appropriate in the public interest or for the protection of investors, withdraw from registration by filing a written notice of withdrawal with the Council. If

the Council finds that any such clearing agency is no longer in existence or has ceased to do business in the capacity specified in its application for registration, the Council, by order, shall cancel its registration.

(d) No clearing agency registered pursuant to this section shall, directly or indirectly, engage in any activity as clearing agency in contravention of such rules and regulations (A) as the Council may prescribe as necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of this title, or (B) as the appropriate regulatory agency for such clearing agency may prescribe as necessary or appropriate for the safeguarding of securities and funds.

(e)(1) The appropriate regulatory agency for a government-related securities clearing agency shall file with the Council notice of the commencement of any proceeding and a copy of any order entered by such appropriate regulatory agency against such clearing agency.

(2) The appropriate regulatory agency for a government-related securities clearing agency shall notify the Council and make a report of any examination conducted by it of such clearing agency, and, upon request, furnish to the Council a copy of such report and any data supplied to it in connection with such examination.

SECTION 8. Recordkeeping and Reporting.

(a)(1) Every government-related securities broker, government-related securities dealer, and government-related securities clearing agency registered with the Council shall make and keep for prescribed periods such records, furnish such copies thereof, and make and disseminate such reports as the Council, by rule, prescribes as necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of this title.

(2) Every such clearing agency shall also make and keep for prescribed periods such records, furnish such copies thereof, and make and disseminate such reports, as the

appropriate regulatory agency for such clearing agency, by rule, prescribes as necessary or appropriate for the safeguarding of securities and funds in the custody or control of such clearing agency or for which it is responsible.

(b) Every government-related securities broker and government-related securities dealer (other than a bank) shall annually file with the Securities and Exchange Commission a balance sheet and income statement which, for any fiscal year beginning one hundred twenty days after enactment of the 1980 Act, shall be certified by an independent public accountant, prepared on a calendar or fiscal year basis, and such other financial statements (which shall, as the Council specifies, be certified) and information concerning its financial condition as the Council by rule may prescribe as necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of this title.

SECTION 9. <u>Oversight of the FMSRB and Government-Related Securities Clearing Agencies.</u>

(a)(1) The FMSRB and every government-related securities clearing agency shall file with the Council, in accordance with such rules as the Council may prescribe, copies of any proposed rule or any proposed change in, addition to, or deletion from the rules of such organization (hereinafter in this subsection collectively referred to as a "proposed rule change") accompanied by a concise general statement of the basis and purpose of such proposed rule change. The Council shall, upon the filing of any proposed rule change, publish notice thereof together with the terms of substance of the proposed rule change or a description of the subjects and issues involved. The Council shall give interested persons an opportunity to submit written data, views, and arguments concerning such proposed rule change and shall consult with all interested agencies, as defined in section 3(a)(6) of the 1980 Act, concerning the advisability of approving the proposed rule change. No proposed rule change shall take effect unless approved by the Council or otherwise permitted in accordance with the provisions of this subsection.

(2) Within thirty-five days of the date of publication of notice of the filing of a proposed rule change in accordance with paragraph (1) of this subsection, or within such longer period as the Council may designate up to ninety days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or as to which the FMSRB or government-related securities clearing agency consents, the Council shall --

(A) by order approve such proposed rule change, or

(B) institute proceedings to determine whether the proposed rule change should be disapproved. Such proceedings shall include notice of the grounds for disapproval under consideration and opportunity for hearing and be concluded within sixty days of the date of publication of notice instituting proceedings. At the conclusion of such proceedings the Council, by order, shall approve or disapprove such proposed rule change. The Council may extend the time for conclusion of such proceedings for up to sixty days if it finds good cause for such extension and publishes its reasons for so finding or for such longer period as to which the FMSRB or government-related securities clearing agency consents.

The Council shall approve a proposed rule change of the FMSRB or a government-related securities clearing agency if it finds that such proposed rule change is consistent with the requirements of this title and the rules and regulations thereunder applicable to such organization. The Council shall disapprove such a proposed rule change if it does not make such finding. The Council shall not approve any proposed rule change prior to the thirtieth day after the date of publication of notice of the filing thereof, unless the Council finds good cause for so doing and publishes its reasons for so finding.

(3)(A) Notwithstanding the provisions of paragraph (2) of this subsection, a proposed rule change may take effect upon filing with the Council if designated by the FMSRB or government-related securities clearing agency as (i) constituting a stated policy, practice, or interpretation with respect to the meaning, administration, or enforcement of an existing rule of such organization, (ii) establishing or

changing a due, fee, or other charge imposed by the organization, or (iii) concerned solely with the administration of the organization or other matters which the Council, by rule, consistent with the public interest and the purposes of this subsection, may specify as without the provisions of such paragraph (2).

(B) Notwithstanding any other provision of this subsection, a proposed rule change may be put into effect summarily if it appears to the Council that such action is necessary for the protection of investors, the maintenance of fair and orderly markets, or the safeguarding of securities or funds. Any proposed rule change so put into effect shall be filed promptly thereafter in accordance with the provisions of paragraph (1) of this subsection.

(C) Any proposed rule change of the FMSRB or a government-related securities clearing agency which has taken effect pursuant to subparagraph (A) or (B) of this paragraph may be enforced to the extent it is not inconsistent with the provisions of this title, the rules and regulations thereunder, and applicable Federal and State law. At any time within sixty days of the date of filing of such a proposed rule change in accordance with the provisions of paragraph (1) of this subsection, the Council summarily may abrogate the change in the rules of the organization made thereby and require that the proposed rule change be refiled in accordance with the provisions of paragraph (1) of this subsection and reviewed in accordance with the provisions of paragraph (2) of this subsection, if it appears to the Council that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of this title. Council action pursuant to the preceding sentence shall not affect the validity or force of the rule change during the period it was in effect and shall not be reviewable under section 10 of the 1980 Act nor deemed to be "final agency action" for purposes of 5 U.S.C. 704.

(b) The Council, by rule, may abrogate, add to, and delete from (hereinafter in this subsection collectively referred to as "amend") the rules of the FMSRB or the rules of a government-related securities clearing agency (insofar as they relate to government-related securities) as the Council deems necessary or appropriate to insure the fair administration of the FMSRB or such government-related securities clearing agency, to conform its rules to the requirements of this title and the rules and regulations thereunder applicable to it, or otherwise in furtherance of the purposes of this title, in accordance with the procedures set forth in subsection 19(c) of the Securities Exchange Act of 1934, substituting the term "Council" for each reference therein to the "Commission". For purposes of this subsection, the FMSRB and any government-related securities clearing agency shall each be deemed to be a "self-regulatory organization" as that term is used in section 19(c) of the Securities Exchange Act of 1934.

SECTION 10. Rules, Regulations, and Orders.

(a) The Council shall have the power to make such rules and regulations as may be necessary or appropriate to implement the provisions of the 1980 Act for which it is responsible or for the execution of the functions vested in it by the 1980 Act, and may, for such purposes, classify persons, government-related securities, transactions, statements, applications, reports, and other matters within its jurisdiction, and prescribe greater, lesser, or different requirements for different classes thereof. No provision of the 1980 Act imposing any liability shall apply to any act done or omitted in good faith in conformity with a rule, regulation, or order of the Council or any government-related securities clearing agency, notwithstanding that such rule, regulation, or order may thereafter be amended or rescinded or determined by judicial or other authority to be invalid for any reason.

(b) The Council, in making rules and regulations pursuant to any provisions of the 1980 Act, shall consult with all interested agencies concerning the impact of any proposed rule or regulation on the markets for their respective securities and shall also consider among other matters the impact any such rule or regulation would have on competition. The Council shall not adopt any such rule or

such securities. Any action taken or directed to be taken by the Council pursuant to this subsection shall expire at the end of ninety days, or such shorter period as established by the Council.

SECTION 11. Annual Reports.

(a)(1) The Council shall make an annual report to the Congress on its work for the preceding year, and shall include in each such report whatever information, data, and recommendations for further legislation it considers advisable with regard to matters within its jurisdiction under the 1980 Act.

(2) The Council shall include in its annual report to the Congress for each fiscal year a summary of its oversight activities under the 1980 Act with respect to the FMSRB, including a description of any examination of the FMSRB conducted as part of such activities, any material recommendation presented as part of such activities to the FMSRB for changes in its organization or rules, and any action by the FMSRB in response to any such recommendation.

(3) The Council shall also include in its annual report to the Congress for each fiscal year --

(A) a statement and analysis of the expenses and operations of the FMSRB in connection with the performance of its responsibilities under the 1980 Act, for which purpose data pertaining to such expenses and operations shall be made available by the FMSRB to the Council at its request; and

(B) a statement detailingits administration of the Freedom of Information Act, 5 U.S.C. 552, including a copy of the report filed pursuant to subsection (d) of such section.

SECTION 12. Court Reviews of Orders and Rules.

(a) A person aggrieved by a final order of the Council entered pursuant to this title may obtain a review of the order in the United States Court of Appeals for the

circuit in which he resides or has his principal place of business, or, for the District of Columbia Circuit, by filing in such court, within sixty days after the entry of such order, a written petition requesting that the order be modified or set aside in whole or in part. A copy of the petition shall be transmitted forthwith by the clerk of the court to any member of the Council, or an officer designated by the Council for that purpose. Thereupon the Council shall file in the court the record on which the order complained of is entered, as provided in the Federal Rules of Appellate Procedure, 28 U.S.C. 2112. On the filing of the petition, the court has jurisdiction, which becomes exclusive on the filing of the record, to affirm or modify and enforce or to set aside the order, in whole or in part. No objection to the order of the Council shall be considered by the court unless such objection shall have been urged before the Council. The findings of the Council as to the facts, if supported by substantial evidence, are conclusive. If either party applies to the court for leave to adduce additional evidence and shows to the satisfaction of the court that such additional evidence is material and that there were reasonable grounds for failure to adduce it before the Council, the court may remand the case to the Council for further proceedings, in whatever manner and on whatever conditions the court considers appropriate. The Council may modify its findings as to the facts, by reason of the additional evidence so taken, and it shall file such modified or new findings, which, if supported by substantial evidence, shall be conclusive, and its recommendation, if any, for the modification or setting aside of the original order. The judgment and decree of the court, affirming, modifying, and enforcing or setting aside, in whole or in part, any such order of the Council, shall be final, subject to review by the Supreme Court of the United States upon certiorari or certification as provided in sections 239 and 240 of the Judicial Code, 28 U.S.C. 346, 347, as amended.

(b) The commencement of proceedings under subsection (a) shall not, unless specifically ordered by the court, operate as a stay of the Council's order.

SECTION 13. Application of the Commodity Exchange Act.

No action taken pursuant to the provisions of the 1980 Act and no action of a government-related securities

clearing agency shall be considered to create a contract market, or other board of trade, exchange or market, as those terms are used in the Commodity Exchange Act, as amended, 7 U.S.C. 1 et seq.

TITLE II --

*SECTION 1. Section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78c) is amended as follows:

(1) Paragraph (12) of subsection (a) thereof is amended by inserting the following directly preceding the reference to "any interest or participation in any common trust fund":

"(12) The term 'exempted security' or 'exempted securities' includes securities which are direct obligations of, or obligations guaranteed as to principal or interest by, the United States; such securities issued or guaranteed by corporations in which the United States has a direct or indirect interest as shall be designated for exemption by the Secretary of the Treasury as necessary or appropriate in the public interest or for the protection of investors: <u>Provided, however, That government-related securities, as defined in section 3(a)(43) of this title, shall not be deemed to be 'exempted securities' for purposes of sections 15 (except subsections (a), (b)(9), (b)(11), (c)(2), (c)(3), (c)(5), and (c)(6) thereof), and 15A (except subsections (b)(6), (b)(11), and (g)(3) thereof) of this title;</u> municipal securities as defined in section 3(a)(29) of this title: Provided, however, That municipal securities shall not be deemed to be 'exempted securities' for purposes of sections 15, 15A (except subsections (b)(6), (b)(11), and (g)<u>(3)</u> thereof), and 17A of this title;"

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* <u>Underlining</u> indicates additions to the Securities Exchange Act of 1934; ^ indicates deletions.

(2) Paragraph (26) of subsection (a) thereof is amended to read as follows:

"(26) The term 'self-regulatory organization' means any national securities exchange, registered securities association or registered clearing agency, or (solely for purposes of sections 19(b), 19(c), and 23(b) of this title) the Municipal Securities Rulemaking Board established by section 15B of this title, or (solely for purposes of sections 17(d), 19(d), 19(e), 19(f), 19(g), and 19(h)) a clearing agency registered pursuant to section 7 of the Government-Related Securities Act of 1980."

(3) Paragraph (30) of subsection (a) thereof is amended to read as follows:

"(30) The term 'municipal securities dealer' means a public securities dealer engaged in the business of buying and selling municipal securities for his own account, through a broker or otherwise.".

(4) Paragraph (32) of subsection (a) thereof is amended to read as follows:

"(32) The term 'person associated with a public securities dealer' when used with respect to a public securities dealer which is a bank or a division or department of a bank means any person directly engaged in the management, direction, supervision, or performance of any of the public securities dealer's activities with respect to municipal securities or government-related securities, and any person directly or indirectly controlling such activities or controlled by the public securities dealer in connection with such activities.".

(5) Subparagraph (A) of paragraph (34) of subsection (a) thereof is amended by striking each reference to the term "municipal securities dealer" and inserting in lieu thereof the term "public securities dealer".

(6) Subparagraphs (B) and (C) of paragraph (39) of subsection (a) thereof are amended by striking each reference to the term "municipal securities dealer" and inserting in lieu thereof the term "public securities dealer".

(7) Subsection (a) is further amended by adding at the end thereof the following new paragraphs:

"(41) The term 'public securities dealer' means any person (including a separately identifiable department or division of a bank) engaged in the business of buying and selling municipal securities or government-related securities for his own account, through a broker or otherwise, but does not include --

"(A) any person insofar as he buys or sells such securities for his own account, either individually or in some fiduciary capacity, but not as a part of a regular business; or

"(B) a bank, unless the bank is engaged in the business of buying and selling municipal securities or government-related securities for its own account other than in a fiduciary capacity, through a broker or otherwise: Provided, however, That if the bank is engaged in such business through a separately identifiable department or division (as defined in section 3(a)(42) of this title) the department or division and not the bank itself shall be deemed to be the public securities dealer.

"(42) The term 'separately identifiable department or division', as that term is used in subsection 3(a)(41) of this title, means that unit of a bank which --

"(A) conducts the trading, sales, and operations activities of the bank relating to the conduct of its business as a public securities dealer, and

"(B) is organized and administered to permit independent examination, periodic inspection, and enforcement of applicable provisions of this title, the rules and regulations thereunder, the rules of the Municipal Securities Rulemaking Board, and the rules of the Federal Mortgage-Backed Securities Rulemaking Board. A separately identifiable department or division of a bank may be engaged in activities other than those relating to municipal securities or government-related securities.

"(43) The term 'government-related securities' means those securities subject to regulation under the Government-Related Securities Act of 1980.

"(44) The term 'government-related securities dealer' means a public securities dealer engaged in the business of buying and selling government-related securities for his own account, through a broker or otherwise.

"(45) The term 'government-related securities broker' means a broker engaged in the business of effecting transactions in government-related securities for the account of others.

"(46) The term 'registered,'when used with respect to a broker, dealer, public securities dealer, or clearing agency means registered with the Commission unless otherwise indicated.".

(8) Subsection (c) thereof is amended to read as follows:

(c) No provision of this title shall apply to, or be deemed to include, any agency, corporation, or instrumentality of the United States or in which the United States has a direct or indirect interest, or any officer, agent, or employee of any such agency, corporation, or instrumentality acting in the course of his official duty as such, unless such provision makes specific reference to such agency, corporation, or instrumentality.

(9) Subsection (d) thereof is amended to read as follows:

"(d) No issuer of municipal securities or officer or employee thereof acting in the course of his official duties as such shall be deemed to be a 'broker', 'dealer', or 'public securities dealer' solely by reason of buying, selling, or effecting transactions in the issuer's securities.".

SECTION 2. Section 6(b) of the Securities Exchange Act of 1934 (15 U.S.C. 78f(b)) is amended as follows:

(1) Paragraph (1) thereof is amended to read as follows:

"(1) Such exchange is so organized and has the capacity to be able to carry out the purposes of this title and to comply, and (subject to any rule or order of the Commission pursuant to section 17(d) or 19(g)(2) of this title) to enforce compliance by its members and persons associated with its members, with the provisions of this title, the rules and regulations thereunder, the rules of the Federal Mortgage-Backed Securities Rulemaking Board, and the rules of the exchange.".

(2) Paragraph (6) thereof is amended to read as follows:

"(6) The rules of the exchange provide that (subject to any rule or order of the Commission pursuant to section 17(d) or 19(g)(2) of this title) its members and persons associated with its members shall be appropriately disciplined for violation of the provisions of this title, the rules or regulations thereunder, the rules of the Federal Mortgage-Backed Securities Rulemaking Board, or the rules of the exchange, by expulsion, suspension, limitation of activities, functions, and operations, fine, censure, being suspended or barred from being associated with a member, or any other fitting sanction.".

SECTION 3. Section 7 of the Securities Exchange Act of 1934 (15 U.S.C. 78g) is amended as follows:

(1) Paragraphs (a) through (d) thereof are amended to reads as follows:

"(a) For the purpose of preventing the excessive use of credit for the purchase or carrying of securities and to preserve the financial integrity of the markets for government-related securities, the Board of Governors of the Federal Reserve System shall, prior to October 1, 1934 and from time to time thereafter, prescribe rules and regulations with respect to the amount of credit that may be initially extended and subsequently maintained on any security (other than an exempted security) and, if it is deemed necessary by the Board of Governors of the Federal Reserve System the minimum deposit required and subsequently maintained in connection with the purchase, sale, or carrying of a government-related security. Any action taken by the Board of Governors of the Federal Reserve System under this authority with respect to a government-related security shall supercede any rule of the Federal Mortgage-Backed

Securities Rulemaking Board or of the Government-Related Securities Oversight Council that is inconsistent therewith. For the initial extension of credit on any security other than a government-related security, such rules and regulations shall be based upon the following standard: An amount not greater than whichever is the higher of--

(1) 55 per centum of the current market price of the security, or

(2) 100 per centum of the lowest market price of the security during the preceding thirty-six calendar months, but not more than 75 per centum of the current market price.

Should the Board of Governors of the Federal Reserve System determine that it is necessary for it to prescribe requirements with respect to the initial or subsequent maintenance of a deposit in connection with the purchase, sale, or carrying of a government-related security, such rules and regulations shall require such amount as the Board of Governors of the Federal Reserve System shall deem necessary in order to further the purposes of this title. Such rules and regulations may make appropriate provision with respect to the carrying of undermargined accounts for limited periods and under specified conditions; the withdrawal of funds or securities; the substitution or additional purchases of securities; the transfer of accounts from one lender to another; special or different margin requirements for delayed deliveries, short sales, arbitrage transactions, and securities to which paragraph (2) of this subsection does not apply; the bases and the methods to be used in calculating loans, and margins and market prices; and similar administrative adjustments and details. For the purposes of paragraph (2) of this subsection, until July 1, 1936, the lowest price at which security has sold on or after July 1, 1933, shall be considered as the lowest price at which such security has sold during the preceding thirty-six calendar months.

"(b) Notwithstanding the provisions of subsection (a) of this section, the Board of Governors of the Federal Reserve System, may, from time to time, with respect to all or specified securities or transactions, or classes of securities, or classes of transactions, by such rules and regulations (1) prescribe such lower margin requirements for

the initial extension or maintenance of credit as it deems necessary or appropriate for the accommodation of commerce and industry, having due regard to the general credit situation of the country, and (2) prescribe such higher margin requirements for the initial extension or maintenance of credit as it may deem necessary or appropriate to prevent the excessive use of credit to finance transactions in securities or to preserve the financial integrity of the markets for government-related securities."

"(c) It shall be unlawful for any member of a national securities exchange or any broker, dealer, or government-related securities dealer, directly or indirectly to extend or maintain credit or arrange for the extension or maintenance of credit to or for any customer--

(1) On any security (other than an exempted security), in contravention of the rules and regulations which the Board of Governors of the Federal Reserve System shall prescribe under subsections (a) and (b) of this section.

(2) Without collateral or on any collateral other than securities, except in accordance with such rules and regulations as the Board of Governors of the Federal Reserve System may prescribe (A) to permit under specified conditions and for a limited period any such member, broker, dealer, or government-related securities dealer to maintain a credit initially extended in conformity with the rules and regulations of the Board of Governors of the Federal Reserve System, and (B) to permit the extension or maintenance of credit in cases where the extension or maintenance of credit is not for the purpose of purchasing or carrying securities or of evading or circumventing the provisions of paragraph (1) of this subsection."

"(d) It shall be unlawful for any person not subject to subsection (c) of this section to extend or maintain credit or to arrange for the extension or maintenance of credit for the purpose of purchasing or carrying any security, in contravention of such rules and regulations as the Board of Governors of the Federal Reserve System shall prescribe to prevent the excessive use of credit for the purchasing or carrying of or trading in securities or to preserve the

financial integrity of the markets for government-related securities in circumvention of the other provisions of this section. Such rules and regulations may impose upon all extensions of credit and deposit requirements for the purpose of purchasing or carrying securities limitations similar to those imposed upon members, brokers, dealers, or government-related securities dealers by subsection (c) of this section and the rules and regulations thereunder. This subsection and the rules and regulations thereunder shall not apply (A) to a loan made by a person not in the ordinary course of his business, (B) to a loan on an exempted security, (C) to a loan to a dealer to aid in the financing of the distribution of securities to customers not through the medium of a national securities exchange, (D) to an extension of credit by a bank on a security other than an equity security or a government-related security or (E) to such other loans as the Board of Governors of the Federal Reserve System shall, by such rules and regulations as it may deem necessary or appropriate in the public interest or for the protection of investors, exempt, either unconditionally or upon specified terms and conditions or for stated periods, from the operation of this subsection and the rules and regulations thereunder."

(2) Subparagraph (B) of paragraph (2) of subsection (f) thereof is amended to read as follows:

"(B) The term "United States security" means (i) a security (other than an exempted security) issued by a person incorporated under the laws of any State, or whose principal place of business is within a State, and (ii) a government-related security."

SECTION 4. Section 15 of the Securities Exchange Act of 1934 (15 U.S.C. 78o) is amended as follows:

(1) The caption thereof is amended to read as follows: "REGISTRATION AND REGULATION OF BROKERS, DEALERS, AND PUBLIC SECURITIES DEALERS".

(2) Paragraph (1) of subsection (a) thereof is amended to read as follows:

"(1) It shall be unlawful for any broker or dealer which is either a person other than a natural person or a

natural person not associated with a broker or dealer which is a person other than a natural person (other than such a broker or dealer whose business is exclusively intrastate and who does not make use of any facility of a national securities exchange) or for any public securities dealer to make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any security (other than an exempted security or commercial paper, bankers' acceptances, or commercial bills) unless such broker, dealer, or public securities dealer is registered in accordance with subsection (b) of this section.".

(3) Subsection (a) thereof is further amended by striking paragraph (2) and inserting the following as paragraphs (2) and (3):

"(2) Any provision of this title (other than section 5 or subsection (a)(1) of this section) which prohibits any act, practice, or course of business if the mails or any means or instrumentality of interstate commerce is used in connection therewith shall also prohibit any such act, practice, or course of business by any registered broker, dealer, or public securities dealer or any person acting on behalf of such broker, dealer, or public securities dealer, irrespective of any use of the mails or any means or instrumentality of interstate commerce in connection therewith.

"(3) The Commission, by rule or order, upon its own motion or upon application, may conditionally or unconditionally exempt any broker, dealer, or public securities dealer or class of brokers, dealers, or public securities dealers from any provision of this section, or any rule of the Municipal Securities Rulemaking Board, if the Commission deems such exemption consistent with the public interest, the protection of investors, and the purposes of this title.".

(4) That part of paragraph (1) which precedes the dash and subparagraph (A) of paragraph (2) of subsection (b) thereof are amended to read as follows:

"(1) A broker, dealer, or public securities dealer may be registered by filing with the Commission an application for registration in such form and containing such informa-

tion and documents concerning such broker, dealer, or public securities dealer and any persons associated with such broker, dealer, or public securities dealer as the Commission, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors. Within forty-five days of the date of the filing of such application (or within such longer period as to which the applicant consents), the Commission shall --

* * * * *

"(2)(A) An application for registration of a broker, dealer, or public securities dealer to be formed or organized may be made by a broker, dealer, or public securities dealer to which the broker, dealer, or public securities dealer to be formed or organized is to be the successor. Such application, in such form as the Commission, by rule, may prescribe, shall contain such information and documents concerning the applicant, the successor, and any persons associated with the applicant or the successor, as the Commission, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors. The grant or denial of registration to such an applicant shall be in accordance with the procedures set forth in paragraph (1) of this subsection. If the Commission grants such registration, the registration shall terminate on the forty-fifth day after the effective date thereof, unless prior thereto the successor shall, in accordance with such rules and regulations as the Commission may prescribe, adopt the application for registration as its own.".

(5) Subsection (b) thereof is further amended by striking paragraph (3), and redesignating subparagraph (C) of paragraph (2) as paragraph (3).

(6) Redesignated paragraph (3) is amended to read as follows:

"(3) Within six months of the date of the granting of registration pursuant to this section or section 5 of the Government-Related Securities Act of 1980 to a broker or dealer, the Commission, or upon the authorization and direction of the Commission, a registered securities

association or national securities exchange of which such broker or dealer is a member, shall conduct an inspection of the broker or dealer to determine whether it is operating in conformity with the provisions of this title and the rules and regulations thereunder: Provided, however, That the Commission may delay such inspection of any class of brokers or dealers for a period not to exceed six months".

(7) That part of paragraph (4) which precedes the dash, subsection (ii) of subparagraph (B), subparagraphs (C) and (D), that part of subparagraph (E) which precedes the dash, and subparagraph (F) of paragraph (4) of subsection (b) thereof are amended to read as follows:

"(4) The Commission, by order, shall censure, place limitations on the activities, functions, or operations of, suspend for a period not exceeding twelve months, or revoke the registration with the Commission or with the Government-Related Securities Oversight Council of any broker, dealer, or public securities dealer if it finds, on the record after notice and opportunity for hearing, that such censure, placing of limitations, suspension, or revocation is in the public interest and that such broker, dealer, or public securities dealer, whether prior or subsequent to becoming such, or any person associated with such broker, dealer, or public securities dealer, whether prior or subsequent to becoming so associated --

* * * * *

"(B)(ii) arises out of the conduct of the business of a broker, dealer, public securities dealer, investment adviser, bank, insurance company, or fiduciary;

* * * * *

"(C) is permanently or temporarily enjoined by order, judgment, or decree of any court of competent jurisdiction from acting as an investment adviser, underwriter, broker, dealer, or public securities dealer, or as an affiliated person or employee of any investment company, bank, or insurance company, or from engaging in or continuing any conduct or practice in connection with any such activity, or in connection with the purchase or sale of any security.

"(D) has willfully violated any provision of the Securities Act of 1933, the Investment Advisers Act of 1940, the Investment Company Act of 1940, this title, the rules or regulations under any of such statutes, the rules of the Municipal Securities Rulemaking Board, or the rules of the Federal Mortgage-Backed Securities Rulemaking Board, or is unable to comply with any such provision.

"(E) has willfully aided, abetted, counseled, commanded, induced, or procured the violation by any other person of any provision of the Securities Act of 1933, the Investment Advisers Act of 1940, the Investment Company Act of 1940, this title, the rules or regulations under any of such statutes, the rules of the Municipal Securities Rulemaking Board, or the rules of the Federal Mortgage-Backed Securities Rulemaking Board, or has failed reasonably to supervise, with a view to preventing violations of the provisions of such statutes, rules, and regulations, another person who commits such a violation, if such other person is subject to his supervision. For the purposes of this subparagraph (E) no person shall be deemed to have failed reasonably to supervise any other person, if --

* * * * *

"(F) is subject to an order entered pursuant to paragraph (6) or (7) of this subsection (b) barring or suspending the right of such person to be associated with a broker, dealer, or public securities dealer.

(8) Paragraphs (5) and (6) of subsection (b) thereof are amended to read as follows:

"(5) Pending final determination whether any registration under this subsection or under section 5 of the Government-Related Securities Act of 1980 shall be revoked, the Commission, by order, may suspend such registration, if such suspension appears to the Commission, after notice and opportunity for hearing, to be necessary or appropriate in the public interest or for the protection of investors. Any

registered broker, dealer, or public securities dealer may, upon such terms and conditions as the Commission deems necessary or appropriate in the public interest or for the protection of investors, withdraw from registration by filing a written notice of withdrawal with the Commission. If the Commission finds that any registered broker, dealer, or public securities dealer is no longer in existence or has ceased to do business as a broker, dealer, or public securities dealer, the Commission, by order, shall cancel the registration of such broker, dealer, or public securities dealer.".

"(6) The Commission, by order, shall censure or place limitations on the activities or functions of any person associated, or seeking to become associated, with a broker, dealer, or public securities dealer, or suspend for a period not exceeding twelve months or bar any such person from being associated with a broker, dealer, or public securities dealer, if the Commission finds, on the record after notice and opportunity for hearing, that such censure, placing of limitations, suspension, or bar is in the public interest and that such person has committed or omitted any act or omission enumerated in subparagraph (A), (D), or (E) of paragraph (4) of this subsection, has been convicted of any offense specified in subparagraph (B) of said paragraph (4) within ten years of the commencement of the proceedings under this paragraph, or is enjoined from any action, conduct, or practice specified in subparagraph (C) of said paragraph (4). It shall be unlawful for any person as to whom an order entered pursuant to this paragraph or pursuant to paragraph (7) suspending or barring him from being associated with a broker, dealer, or public securities dealer is in effect willfully to become, or to be, associated with a broker, dealer, or public securities dealer without the consent of the Commission, and it shall be unlawful for any broker, dealer, or public securities dealer to permit such a person to become, or remain, a person associated with him without the consent of the Commission, if such broker, dealer, or public securities dealer knew, or in the exercise of reasonable care should have known, of such order.".

(9) Subsection (b) thereof is further amended by redesignating paragraphs (7), (8), (9), and (10) as paragraphs (9), (10), (11), and (12), respectively, and by inserting the following as paragraphs (7) and (8):

"(7) With respect to any public securities dealer for which the Commission is not the appropriate regulatory agency, the appropriate regulatory agency for such public securities dealer may sanction any such public securities dealer in the manner and for the reasons specified in paragraph (4) of this subsection and any person associated with such public securities dealer in the manner and for the reasons specified in paragraph (6) of this subsection. In addition, such appropriate regulatory agency may, in accordance with section 8 of the Federal Deposit Insurance Act (12 U.S.C. 1818), enforce compliance by such public securities dealer or any person associated with such public securities dealer with the provisions of this section, sections 15B and 17 of this title, the provisions of the Government-Related Securities Act of 1980, any rule or regulation under any such provision, the rules of the Municipal Securities Rulemaking Board, the rules of the Federal Mortgage-Backed Securities Rulemaking Board, and the rules of the Commission pertaining to public securities dealers, persons associated with public securities dealers, and transactions in municipal securities and government-related securities. For purposes of the preceding sentence, any violation of any such provision shall constitute adequate basis for the issuance of any order under section 8(b) or 8(c) of the Federal Deposit Insurance Act, and the customers of any such public securities dealer shall be deemed to be 'depositors' as that term is used in section 8(c) of that Act. Nothing in this paragraph shall be construed to affect in any way the powers of such appropriate regulatory agency to proceed against such public securities dealer under any other provision of law.

"(8)(A) The Commission, prior to the entry of an order of investigation, or commencement of any proceedings, against any public securities dealer, or person associated with any public securities dealer, for which the Commission is not the appropriate regulatory agency, for violation of any provision of section 15 or 15B of this title, any rule or regulation under any such section, any provision of the Government-Related Securities Act of 1980, any rule or regulation under any such provision, any rule of the Municipal Securities Rulemaking Board, or any rule of the Federal Mortgage-Backed Securities Rulemaking Board, shall (i) give notice to the appropriate regulatory agency for

such public securities dealer of the identity of such public securities dealer or person associated with such public securities dealer and the nature of and basis for such proposed action, and (ii) consult with such appropriate regulatory agency concerning the effect of such proposed action on sound banking practices and the feasibility and desirability of coordinating such action with any proceeding or proposed proceeding by such appropriate regulatory agency against such public securities dealer or associated person.

"(B) The appropriate regulatory agency for a public securities dealer (if other than the Commission), prior to the entry of an order of investigation, or commencement of any proceedings, against such public securities dealer or person associated with such public securities dealer, for violation of any provision of this section, section 7 or section 15B of this title, the rules of the Municipal Securities Rulemaking Board, the rules of the Federal Mortgage-Backed Securities Rulemaking Board, or the rules or regulations of the Commission or the Board of Governors of the Federal Reserve System pertaining to public securities dealers, persons associated with public securities dealers, or transactions in municipal securities or government-related securities shall (i) give notice to the Commission of the identity of such public securities dealer or person associated with such public securities dealer and the nature of and basis for such proposed action, and (ii) consult with the Commission concerning the effect of such proposed action on the protection of investors and the feasibility and desirability of coordinating such action with any proceeding or proposed proceeding by the Commission against such public securities dealer or associated person.

"(C) Prior to the entry of an order of investigation or the commencement of any proceeding against a government-related securities broker or government-related securities dealer for violation of any provision of the Government-Related Securities Act of 1980, any rule or regulation thereunder, or the rules of the Federal Mortgage-Backed Securities Rulemaking Board, the Commission and any other appropriate regulatory agency shall (i) notify the Government-Related Securities Oversight Council of the nature of and basis for such proposed action, and (ii)

consult with the Government-Related Securities Oversight Council concerning the effect of such proposed action on the protection of investors, the monetary policy of the United States, and the orderly regulation of the government-related securities markets.

"(D) Nothing in this paragraph shall be construed to impair or limit (other than by the requirement of prior consultation) the power of the Commission or the appropriate regulatory agency for a public securities dealer to initiate any action of a class described in this paragraph or to affect in any way the power of the Commission or such appropriate regulatory agency to initiate any other action pursuant to this title or any other provision of law.".

(10) Paragraphs (1) and (2) of subsection (c) thereof are amended by striking each reference to the term "municipal securities dealer" and inserting in lieu thereof the term "public securities dealer". Paragraph (1) of subsection (c) thereof is further amended by adding the words "or government-related security" after the words "any municipal security".

SECTION 5. Section 15A of the Securities Exchange Act of 1934 (15 U.S.C. 78o-3) is amended as follows:

(1) Paragraphs (2) and (3) of subsection (b) thereof are amended to read as follows:

"(2) Such association is so organized and has the capacity to be able to carry out the purposes of this title and to comply, and (subject to any rule or order of the Commission pursuant to section 17(d) or 19(g)(2) of this title) to enforce compliance by its members and persons associated with its members, with the provisions of this title, the rules and regulations thereunder, the rules of the Municipal Securities Rulemaking Board, the rules of the Federal Mortgage-Backed Securities Rulemaking Board, and the rules of the association.

"(3) Subject to the provisions of subsection (g) of this section, the rules of the association provide that any broker or dealer registered with the Commission or the Government-Related Securities Oversight Council may become a member of such association and any person may become associated with a member thereof.".

(2) Paragraph (7) of subsection (b) thereof is amended to read as follows:

"(7) The rules of the association provide that (subject to any rule or order of the Commission pursuant to section 17(d) or 19(g)(2) of this title) its members and persons associated with its members shall be appropriately disciplined for violation of any provision of this title, the rules or regulations thereunder, the rules of the Municipal Securities Rulemaking Board, the rules of the Federal Mortgage-Backed Securities Rulemaking Board, or the rules of the association, by expulsion, suspension, limitation of activities, functions, and operations, fine, censure, being suspended or barred from being associated with a member, or any other fitting sanction.".

(3) Paragraphs (2) and (3) of subsection (e) thereof are amended to read as follows:

"(2) For the purposes of this subsection, the term 'nonmember professional' shall include (A) with respect to transactions in securities other than municipal securities and government-related securities, any registered broker or dealer who is not a member of any registered securities association, except such a broker or dealer who deals exclusively in commercial paper, bankers' acceptances, and commercial bills, and (B) with respect to transactions in municipal securities and government-related securities, any public securities dealer (other than a bank or division or department of a bank) who is not a member of any registered securities association and any municipal securities broker or government-related securities broker who is not a member of any such association.

"(3) Nothing in this subsection shall be so construed or applied as to prevent (A) any member of a registered securities association from granting to any other member of any registered securities association any dealer's discount, allowance, commission, or special terms, in connection with the purchase or sale of securities, or (B) any member of a registered securities association or any public securities dealer which is a bank or a division or department of a bank from granting to any member of any registered securities association or any such public securities dealer any dealer's discount, allowance, commission, or special terms in connection with the purchase or sale of municipal

securities or government-related securities: Provided, however, That the granting of any such discount, allowance, commission, or special terms in connection with the purchase or sale of municipal securities shall be subject to rules of the Municipal Securities Rulemaking Board adopted pursuant to section 15B(a)(2)(K) of this title.".

(4) Subparagraph (B) of paragraph (1) of subsection (h) thereof is amended to read as follows:

"(B) the specific provisions of this title, the rules or regulations thereunder, the rules of the Municipal Securities Rulemaking Board, the rules of the Federal Mortgage-Backed Securities Rulemaking Board, or the rules of the association which any such act or practice, or omission to act, is deemed to violate; and".

SECTION 6. Section 15B of the Securities Exchange Act of 1934 (15 U.S.C. 78o-4) is amended:

(1) by striking subsection (a) and redesignating subsections (b), (c), and (d) thereof as subsections (a), (b), and (c), respectively;

(2) by striking out "subsection (b)(2)(B) of this section" in the last sentence of redesignated subsection (a)(1), and inserting in lieu thereof "paragraph (a)(2)(B)";

(3) by striking out that part of paragraph (2) of redesignated subsection (a) which precedes the colon and inserting in lieu thereof the following:

"(2) The Board shall propose and adopt rules to effect the purposes of this title with respect to transactions in municipal securities effected by brokers, dealers, and public securities dealers. (Such rules are hereinafter collectively referred to in this section as 'rules of the Board'.) The rules of the Board, as a minimum, shall:";

(4) by striking out "(c)(7)" in paragraph (2)(A)(iii) of redesignated subsection (a) and inserting in lieu of thereof "(b)(2)";

(5) by striking out subparagraph (C) of paragraph (2) of redesignated subsection (a) thereof and inserting in lieu thereof the following:

"(C) be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in municipal securities, to remove impediments to and perfect the mechanism of a free and open market in municipal securities, and, in general, to protect investors and the public interest; and not be designed to permit unfair discrimination between customers, issuers, municipal securities brokers, or municipal securities dealers, to fix minimum profits, to impose any schedule or fix rates of commissions, allowances, discounts, or other fees to be charged by municipal securities brokers or municipal securities dealers, to regulate by virtue of any authority conferred by this title matters not related to the purposes of this title <u>with respect to municipal securities</u> or the administration of the Board, or to impose any burden on competition not necessary or appropriate in furtherance of the purposes of this title.";

(6) by striking out "(c)(7)" in subparagraph (E) of paragraph (2) of redesignated subsection (a) thereof and inserting in lieu thereof "(b)(2)";

(7) by striking out subparagraph (H) of paragraph (2) of redesignated subsection (a) and inserting in lieu thereof the following:

"(H) <u>if the Board deems appropriate, specify activities in addition to those included in section 3(a)(42) of this title which the Board determines are integral to the conduct of business as a municipal securities dealer, and require those activities to be conducted within any separately identifiable department or division.</u>";

(8) by striking out paragraphs (2), (3), (4), (5), and (6) of redesignated subsection (b) and by redesignating paragraphs (7) and (8) thereof as paragraphs (2) and (3), respectively;

(9) by striking out each reference to the term "municipal securities dealer" in paragraph (1) of redesignated subsection (b) thereof and inserting in lieu thereof the term "public securities dealer";

(10) by striking out "subsection (b)(2)(A)(iii)" and "subsection (b)(2)(E)" in redesignated subsection (b)(2) and inserting in lieu thereof "subsection (a)(2)(A)(iii)" and "subsection (a)(2)(E)", respectively.

SECTION 7. Section 17 of the Securities Exchange Act of 1934 (15 U.S.C. 78q) is amended as follows:

(1) Subsections (a) and (c) thereof are amended by striking each reference to the term "municipal securities dealer" and inserting in lieu thereof the term "public securities dealer," and subsection (b) thereof is amended to read as follows:

"(b) All records of persons described in subsection (a) of this section and all records of persons registered pursuant to sections 5 and 7 of the Government-Related Securities Act of 1980 are subject at any time, or from time to time, to such reasonable periodic, special, or other examinations by representatives of the Commission and the appropriate regulatory agency for such persons as the Commission or the appropriate regulatory agency for such persons deems necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of this title: Provided, however, That the Commission shall, prior to conducting any such examination of a clearing agency, transfer agent, or public securities dealer for which it is not the appropriate regulatory agency, give notice to the appropriate regulatory agency for such clearing agency, transfer agent, or public securities dealer of such proposed examination and consult with such appropriate regulatory agency concerning the feasibility and desirability of coordinating such examinations with examinations conducted by such appropriate regulatory agency with a view to avoiding unnecessary regulatory duplication or undue regulatory burdens for such clearing agency, transfer agent, or public securities dealer. Nothing in the proviso to the preceding sentence shall be construed to impair or limit (other than by the

requirement of prior consultation) the power of the Commission under this subsection to examine any clearing agency, transfer agent, or public securities dealer or to affect in any way the power of the Commission under any other provision of this title or otherwise to inspect, examine, or investigate any such clearing agency, transfer agent, or public securities dealer.".

(2) Subparagraph (A) of paragraph (1) of subsection (d) thereof is amended to read as follows:

> "(A) with respect to any person who is a member of or participant in more than one self-regulatory organization, relieve any such self-regulatory organization of any responsibility under this title (i) to receive regulatory reports from such person, (ii) to examine such person for compliance, or to enforce compliance by such person, with specified provisions of this title, the rules and regulations thereunder, the rules of the Federal Mortgage-Backed Securities Rule-making Board, and its own rules, or (iii) to carry out other specified regulatory functions with respect to such person, and".

(3) Subsection (f)(1)(A) thereof is amended to read as follows:

"(f)(1) Every national securities exchange, member thereof, registered securities association, broker, dealer, public securities dealer, registered transfer agent, registered clearing agency, participant therein, member of the Federal Reserve System, and bank whose deposits are insured by the Federal Deposit Insurance Corporation shall --

> "(A) report to the Commission or other person designated by the Commission such information about missing, lost, counterfeit, or stolen securities, in such form and within such time as the Commission, by rule, determines is necessary or appropriate in the public interest or for the protection of investors; such information shall be available on request for a reasonable fee, to any such exchange, member, association, broker, dealer, public securities dealer, transfer agent, clearing agency, participant,

member of the Federal Reserve System, or insured bank, and such other persons as the Commission, by rule, designates; and".

SECTION 8. Section 17A of the Securities Exchange Act of 1934 (15 U.S.C. 78q-1) is amended as follows:

(1) Paragraphs (4), (5), and (6) of subsection (b) thereof are amended to read as follows:

"(4)(A) A clearing agency registered pursuant to this section or section 7 of the Government-Related Securities Act of 1980 may, and in cases in which the Commission, by order, directs as appropriate in the public interest shall, deny participation to any person subject to a statutory disqualification. Any such clearing agency shall file notice with the Commission not less than thirty days prior to admitting any person to participation, if the clearing agency knew, or in the exercise of reasonable care should have known, that such person was subject to a statutory disqualification. The notice shall be in such form and contain such information as the Commission, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors.

"(B) A clearing agency registered pursuant to this section or section 7 of the Government-Related Securities Act of 1980 may deny participation to, or condition the participation of, any person if such person does not meet such standards of financial responsibility, operational capability, experience, and competence as are prescribed by the rules of the clearing agency. Such clearing agency may examine and verify the qualifications of an applicant to be a participant in accordance with procedures established by the rules of the clearing agency.

"(5)(A) In any proceeding by a clearing agency registered pursuant to this section or section 7 of the Government-Related Securities Act of 1980 to determine whether a participant should be disciplined (other than a summary proceeding pursuant to subparagraph (C) of this paragraph), the clearing agency shall bring specific charges, notify such participant of, and give him an opportunity to defend against such charges, and keep a

record. A determination by the clearing agency to impose a disciplinary sanction shall be supported by a statement setting forth --

(i) any act or practice in which such participant has been found to have engaged, or which such participant has been found to have omitted;

(ii) the specific provisions of the rules of the clearing agency which any such act or practice, or ommission to act, is deemed to violate; and

(iii) the sanction imposed and the reasons therefor.

"(B) In any proceeding by a clearing agency registered pursuant to this section or section 7 of the Government-Related Securities Act of 1980 to determine whether a person shall be denied participation or prohibited or limited with respect to access to services offered by the clearing agency, the clearing agency shall notify such person of, and give him an opportunity to be heard upon, the specific grounds for denial or prohibition or limitation under consideration and keep a record. A determination by the clearing agency to deny participation or prohibit or limit a person with respect to access to services offered by the clearing agency shall be supported by a statement setting forth the specific grounds on which the denial or prohibition or limitation is based.

"(C) A clearing agency registered pursuant to this section or section 7 of the Government-Related Securities Act of 1980 may summarily suspend and close the accounts of a participant who (i) has been and is expelled or suspended from any self-regulatory organization, (ii) is in default of any delivery of funds or securities to the clearing agency, or (iii) is in such financial or operating difficulty that the

clearing agency determines and so notifies the appropriate regulatory agency for such participant that such suspension and closing of accounts are necessary for the protection of the clearing agency, its participants, creditors, or investors. A participant so summarily suspended shall be promptly afforded an opportunity for a hearing by the clearing agency in accordance with the provisions of subparagraph (A) of this paragraph. The appropriate regulatory agency for such participant, by order, may stay any such summary suspension on its own motion or upon application by any person aggrieved thereby, if such appropriate regulatory agency determines summarily or after notice and opportunity for hearing (which hearing may consist solely of the submission of affidavits or presentation of oral arguments) that such stay is consistent with the public interest and the protection of investors.

"(6) No clearing agency registered pursuant to this section or section 7 of the Government-Related Securities Act of 1980 shall prohibit or limit access by any person to services offered by any participant therein."

(2) Paragraph (2) of subsection (d) thereof is amended to read as follows:

"(2) With respect to any clearing agency or transfer agent for which the Commission is not the appropriate regulatory agency, the appropriate regulatory agency for such clearing agency or transfer agent may, in accordance with section 8 of the Federal Deposit Insurance Act (12 U.S.C. 1818), enforce compliance by such clearing agency or transfer agent with the provisions of this section, sections 17 and 19 of this title, the rules and regulations thereunder, the Government-Related Securities Act of 1980, and the rules and regulations thereunder. For purposes of the preceding sentence, any violation of any such provision shall constitute adequate basis for the issuance of an order under section 8(b) or 8(c) of the Federal Deposit Insurance Act, and the participants in any such clearing agency and

the persons doing business with any such transfer agent shall be deemed to be "depositors" as that term is used in section 8(c) of that Act.".

SECTION 9. Section 19 of the Securities Exchange Act of 1934 (15 U.S.C. 78s) is amended as follows:

(1) Subparagraph (A) of paragraph (1) of subsection (e) thereof is amended to read as follows:

"(A) if the appropriate regulatory agency for such member, participant, or person associated with a member finds that such member, participant, or person associated with a member has engaged in such acts or practices, or has omitted such acts, as the self-regulatory organization has found him to have engaged in or omitted, that such acts or practices, or omissions to act, are in violation of such provisions of this title, the rules or regulations thereunder, the rules of the Federal Mortgage-Backed Securities Rule-making Board, the rules of the self-regulatory organization, or, in the case of a registered securities association, the rules of the Municipal Securities Rulemaking Board as have been specified in the determination of the self-regulatory organization, and that such provisions are, and were applied in a manner, consistent with the purposes of this title, such appropriate regulatory agency, by order, shall so declare and, as appropriate, affirm the sanction imposed by the self-regulatory organization, modify the sanction in accordance with paragraph (2) of this subsection, or remand to the self-regulatory organization for further proceedings; or".

(2) Subparagraphs (A) and (B) of paragraph (1) of subsection (g) thereof are amended to read as follows:

"(g)(1)(A) in the case of a national securities exchange, with such provisions and the provisions of the rules of the Federal Mortgage-Backed Securities Rulemaking Board by its members and persons associated with its members;

"(B) in the case of a registered securities association, with such provisions, the provisions of the rules of the Federal Mortgage-Backed Securities

Rulemaking Board, and the provisions of the rules of the Municipal Securities Rulemaking Board by its members and persons associated with its members; and."

(3) Paragraph (2) of subsection (g) thereof is amended to read as follows:

"(2) The Commission, by rule, consistent with the public interest, the protection of investors, and the other purposes of this title, may relieve any self-regulatory organization of any responsibility under this title to enforce compliance with any specified provision of this title, the rules or regulations thereunder or the rules of the Federal Mortgage-Backed Securities Rulemaking Board by any member of such organization or person associated with such a member, or any class of such members or persons associated with a member."

(4) Subparagraphs (A) and (B) of paragraph (1) of subsection (h) thereof are amended to read as follows:

"(h)(1)(A) in the case of a national securities exchange, with any such provision or any provision of the rules of the Federal Mortgage-Backed Securities Rulemaking Board by a member thereof or a person associated with a member thereof;

"(B) in the case of a registered securities association, with any such provision, any provision of the rules of the Federal Mortgage-Backed Securities Rulemaking Board or any provision of the rules of the Municipal Securities Rulemaking Board by a member thereof or a person associated with a member thereof; or".

(5) Subparagraphs (A) and (B) of paragraph (2) of subsection (h) thereof are amended to read as follows:

"(A) in the case of a national securities exchange, any provision of the Securities Act of 1933, the Investment Advisers Act of 1940, the Investment Company Act of 1940,

this title, the rules or regulations under any of such statutes or the rules of the Federal Mortgage-Backed Securities Rulemaking Board;

"(B) in the case of a registered securities association, any provision of the Securities Act of 1933, the Investment Advisers Act of 1940, the Investment Company Act of 1940, this title, the rules or regulations under any of such statutes, the rules of the Municipal Securities Rulemaking Board or the rules of the Federal Mortgage-Backed Securities Rulemaking Board; or".

(6) Subparagraphs (A) and (B) of paragraph (3) of subsection (h) thereof are amended to read as follows:

"(h)(3)(A) in the case of a national securities exchange, any provision of the Securities Act of 1933, the Investment Advisers Act of 1940, the Investment Company Act of 1940, this title, the rules or regulations under any of such statutes or the rules of the Federal Mortgage-Backed Securities Rulemaking Board; or

"(B) in the case of a registered securities association, any provision of the Securities Act of 1933, the Investment Advisers Act of 1940, the Investment Company Act of 1940, this title, the rules or regulations under any of such statutes, the rules of the Municipal Securities Rulemaking Board or the rules of the Federal Mortgage-Backed Securities Rulemaking Board.".

(7) Subparagraphs (A) and (B) of paragraph (4) of subsection (h) thereof are amended to read as follows:

"(h)(4)(A) in the case of a national securities exchange, with any such provision or any provision of the rules of the Federal Mortgage-Backed Securities Rulemaking Board by any member or person associated with a member;

"(B) in the case of a registered securities association, with any such provision, any provision of the rules of the Federal Mortgage-Backed Securities Rulemaking Board, or any provision of the rules of the Municipal Securities Rulemaking Board by any member or person associated with a member; or".

SECTION 10. Section 21 of the Securities Exchange Act of 1934 (15 U.S.C. 78u) is amended as follows:

(1) Subsections (a), (d), and (e) thereof are amended to insert "or the rules of the Federal Mortgage-Backed Securities Rulemaking Board," directly following each reference to the "rules of the Municipal Securities Rulemaking Board".

(2) Subsection (g) thereof is amended to read as follows:

"(g) Notwithstanding the provisions of section 1407(a) of title 28, United States Code, or any other provision of law, no action for equitable relief instituted by the Commission pursuant to the securities laws shall be consolidated or coordinated with other actions not brought by the Commission, even though such other actions may involve common questions of fact, unless such consolidation is consented to by the Commission. The term "securities laws" as used herein includes the Securities Act of 1933 (15 U.S.C. 77 et seq.), the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.), the Public Utility Holding Company Act of 1935 (15 U.S.C. 79a et seq.), the Trust Indenture Act of 1939 (15 U.S.C. 77aaa et seq.), the Investment Company Act of 1940 (15 U.S.C. 80a-1 et seq.), the Investment Advisers Act of 1940 (15 U.S.C. 80b-1 et seq.), the Securities Investor Protection Act of 1970 (15 U.S.C. 78aaa et seq), and the Government-Related Securities Act of 1980 (15 U.S.C. ______ et seq.).".

SECTION 11. Section 23 of the Securities Exchange Act of 1934 (15 U.S.C. 78w) is amended as follows:

(1) Paragraph (1) of subsection (a) thereof is amended to read as follows:

"(a)(1) The Commission, the Board of Governors of the Federal Reserve System, and the other agencies enumerated in section 3(a)(34) of this title shall each have power to make such rules and regulations as may be necessary or appropriate to implement the provisions of this title for which they are responsible or for the execution of the

functions vested in them by this title, and may for such purposes classify persons, securities, transactions, statements, applications, reports, and other matters within their respective jurisdictions, and prescribe greater, lesser, or different requirements for different classes thereof. No provision of this title imposing any liability shall apply to any act done or omitted in good faith in conformity with a rule, regulation, or order of the Commission, the Board of Governors of the Federal Reserve System, other agency enumerated in section 3(a)(34) of this title, the Government-Related Securities Oversight Council, any self-regulatory organization, notwithstanding that such rule, regulation, or order may thereafter be amended or rescinded or determined by judicial or other authority to be invalid for any reason."

(2) Paragraph (3) and subparagraph (G) of paragraph (4) of subsection (b) thereof are amended by striking each reference to the term "municipal securities dealer" and inserting in lieu thereof the term "public securities dealer".

SECTION 12. Section 28(b) of the Securities Exchange Act of 1934 (15 U.S.C. 78bb(b)) is amended to read as follows:

"(b) Nothing in this title shall be construed to modify existing law with regard to the binding effect (1) on any member of or participant in any self-regulatory organization of any action taken by the authorities of such organization to settle disputes between its members or participants, (2) on any municipal securities dealer or municipal securities broker of any action taken pursuant to a procedure established by the Municipal Securities Rulemaking Board to settle disputes between municipal securities dealers and municipal securities brokers, (3) on any government-related securities dealer or government-related securities broker of any action taken pursuant to a procedure established by the Federal Mortgage-Backed Securities Rulemaking Board to settle disputes between government-related securities dealers and government-related securities brokers, or (4) of any action described in paragraph (1), (2), or (3) on any person who has agreed to be bound thereby.".

TITLE III ---

SECTION 1. That part of subparagraph (A) of paragraph (2) of subsection (a) of section 3 of the Securities Investor Protection Act of 1970 (15 U.S.C. 78ccc) (the "SIPC Act") which precedes the dash is amended to read as follows:

"(a)(2)(A) Members of SIPC -- SIPC shall be a membership corporation the members of which shall be all persons registered under section 15(b) of the 1934 Act or under section 5 of the Government-Related Securities Act of 1980 as brokers or dealers, other than --".

SECTION 2. Paragraph (2) of subsection (c) of section 4 of the SIPC Act (15 U.S.C. 78ddd) is amended to read as follows:

"(2) General Assessment Authority -- SIPC shall, by bylaw, impose upon its members such assessments as, after consultation with self-regulatory organizations, SIPC may deem necessary and appropriate to establish and maintain the fund and to repay any borrowings by SIPC. Any assessments so made shall be in conformity with contractual obligations made by SIPC in connection with any borrowing incurred by SIPC. Subject to paragraph (3) and subsection (d)(1)(A), any such assessment upon the members, or any one or more classes thereof, including any class of members registered under section 5 of the Government-Related Securities Act of 1980, may, in whole or in part, be based upon or measured by (A) the amount of their gross revenues from the securities business, or (B) all or any of the following factors: the amount or composition of their gross revenues from the securities business, the amount or composition of their gross revenues from the business in government-related securities as that term is defined in section 3(a)(43) of the 1934 Act, the number or dollar volume of transactions effected by them, the number of customer accounts maintained by them or the amounts of cash and securities in such accounts, their net capital, the nature of their activities (whether in the securities business or otherwise) and the consequent risks, or other relevant factors.".

SECTION 3. This Act shall become effective on the date of its enactment except as hereinafter provided. Sections 5 and 7 of the Government-Related Securities Act of 1980, the amendments made by this Act to sections 3(a)(12), 6(b), 15(a), 15A, 19(e), (g) and (h) of the Securities Exchange Act of 1934, and the amendments made by this Act to the Securities Investor Protection Act of 1970 shall become effective one hundred twenty days after the date of enactment of this Act.